

# **FINRA Fines Goldman Sachs for Failing to Prevent Trade-Throughs on SIGMA-X System**

On June 5, 2014, FINRA announced an \$800,000 fine against Goldman Sachs for "failing to have reasonably designed written policies and procedures in place to prevent trade-throughs of protected quotations" in Sigma X, its dark pool. Dark pools allow investors to trade stocks anonymously and report trade data after the deals are completed. The price at which shares are offered for sale in dark pools is not visible to anyone, even those participating in them. These alternative trading systems have been criticized recently for their lack of transparency and because the rise of dark pools has reduced trading on exchanges that publicly quote prices, which could lead to less efficient pricing.

According to FINRA it found that from July 29, 2011 through August 9, 2011, there were approximately 395,119 transactions executed in SIGMA-X where the execution traded through a protected quotation at a price inferior to the National Best Bid and Offer (NBB0). During this eight day trading period, Goldman Sachs was unaware that it was trading through a protected quotation, which was caused by market data latencies at SIGMA-X. Goldman Sachs first became aware that it had traded through a protected quotation after it was contacted directly by several customers, who had caught this problem after reviewing their own execution reports and called to complain.

FINRA's findings further concluded that from 2008-2011, the firm failed to establish, maintain, and enforce written policies and procedures to prevent trade-throughs, pursuant to SEC Rule 611 of Regulation NMS (The Order Protection Rule),

because it was utilizing three inadequate methods to supervise its system. First, the firm used an exception report to compare a sampling of SIGMA-X's market data with an independent data source at the time of an order event. The report, however, had a very limited scope and it only reviewed 20 orders per week when SIGMA-X was executing millions of transactions weekly. Second, the firm monitored the capacity of its market data handling systems on a firm-wide basis; however, this method also proved ineffective because it did not identify market data latencies or potential trade-throughs. Third, the firm's written supervisory procedures regarding SEC Rule 611 identified a report entitled SIGMA X NBB0 Potential Trade Through Report, which was implemented on November 1, 2008 and in use through August 31, 2011. This report compared the execution price of a transaction on SIGMA-X with the NBB0 data used by the firm to execute that trade. Although no members of the firm's Best Execution Committee raised concerns about the effectiveness of this report, it was ineffective and generated very few exceptions because it was designed to detect only transactions that were not executed at or within SIGMA-X's decision-making NBB0 and not to detect trade-throughs that occurred as a result of market data latencies.

Based on these findings, FINRA determined that from November 1, 2008 through August 31, 2011 Goldman Sachs failed to establish, maintain, and enforce written policies and procedures that were reasonably designed to prevent trade-throughs of protected quotations in NMS stocks. FINRA also found that Goldman Sachs failed to regularly "surveil to ascertain the effectiveness of its policies and procedures designed to prevent trade-throughs of protected quotations in NMS stocks." The firm's conduct constitutes violations of SEC Rule 611(a)(1) and SEC Rule 611(a)(2) of Regulation NMS, FINRA Rule 2010 (or NASD Rule 2110 for conduct prior to Dec. 15, 2008), and NASD Rule 3010. In resolving the matter, FINRA considered the fact that Goldman Sachs voluntarily paid

approximately \$1.67 million in restitution to harmed customers. The firm has been censured and fined \$800,000 and, in addition, is required to submit a letter to FINRA when the firm has revised its supervisory policies and procedures to address its deficiencies and must provide the date the revised procedures were implemented.

This settlement is only one in a string of recent enforcement actions targeting dark pools and other anonymous trading platforms. It could serve as a warning to clients to check their own trade execution reports, since dark pools may not be monitored diligently. This settlement could also begin an interesting dialogue about what is reasonable surveillance in the dark pools context.

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