



SEC Proposes Regulation of Dark Pools

The SEC recently released proposed changes to the regulations that govern alternative trading systems, with particular emphasis on requiring additional disclosures by so-called “dark pools.”

If you think about it, the name alone is just about enough to stimulate the urge to regulate.

The proposed rules would, in broad strokes, require alternative trading systems to make real-time disclosures comparable to those required of registered exchanges. Critics of the SEC’s proposals complain that these new rules would hobble a useful marketplace, while supporters believe that the measures are an appropriate step towards maintaining a level playing field among equity investors.

The Background of Dark Pools vs. Exchanges

Securities trading in the U.S. remains a highly competitive field comprising several distinct types of markets. Traditional national securities exchanges, such as the NYSE, are the most well-known variety, and account for the lion’s share of trading volume. There are currently ten exchanges registered with the SEC for trading equity securities. Under current regulations, these exchanges must provide the best bid and offer prices for each stock traded, as well as the last-sale information for each trade. This data is reported through the consolidated quote stream (or more commonly, the “tape”), a universal public information stream available to all investors in real time. (FINRA has detailed trade reporting requirements that prescribe the approach for disseminating this information.) Alternative trading systems, or “ATs,” provide a contrast to registered exchanges. ATs are broker-dealers that match buy and sell orders according to preset, non-discretionary formulas. There are currently 73 active, registered ATs, trading in all types of securities. ATs come in different forms. At one end of the spectrum are electronic communications networks, which report their best orders in the consolidated quote stream (just as registered exchanges do). At the other end of the spectrum are ATs which do not report any orders to the tape. These ATs are known as dark pools, and are the focus of the SEC’s proposed rules.

What Makes a Dark Pool Dark?

Though dark pools do report executed trades for the consolidated trade data, they are not required to (and typically do not) identify the particular dark pool that executed the trade. Dark pools are proprietary markets that arose to meet the needs of traders seeking to exchange large blocks of stock with minimal market impact. An investor selling 1 million shares of a given stock will seek to avoid any chance of “leaking” its intent to the market due to the potential for depressing the stock price. Posting the offer on an exchange, which reports all offers in real time, would all but ensure a negative market reaction; attempting the sale through a standard ATs, which entails significant inter-broker communication, would only lessen this negative impact. A dark pool minimizes

the information leak—and thus the effect on share price—by providing anonymity for the seller and the trade.¹ In a dark pool, the trader signals the intent to buy or sell through indications of interest (“IOIs”) to other participants. The amount of information conveyed in an IOI varies: some mention only the name of the stock and the general size of the trade; others identify the side, size and price information. Somewhere between the two extremes is a point at which the IOI conveys sufficient information to permit the parties to trade; at this point, the IOI is said to be “actionable.”

The SEC’s Concerns with Dark Pools

In the SEC’s view, IOIs unfairly divide the securities market into two tiers: those who are privy to the IOIs and those who are not. Because IOIs are communicated only to fellow members within the dark pool, the public markets do not learn of the proposed trade (and do not have price transparency) until after it settles. This leads to two potentially harmful effects in the eyes of the SEC. First, the dark pool participants use the prices displayed in publicly displayed markets without contributing any pricing information of their own. If enough trading volume for a given stock takes place in dark transactions, then the publicly available price will no longer be accurate. Second, as more trading volume takes place in privately run dark pools, market participants who are not members of the pools may be unable to find sufficient contra-side interest for their offers in the public markets.

The Proposed Rules

To counteract these perceived harms, the SEC proposed three changes to its existing ATS regulations.²

- The definition of “bid” and “offer” under the Exchange Act would be amended to treat certain IOIs as quotations, thus subjecting the IOIs to disclosure requirements.³ An IOI would qualify as a bid or offer when it conveys the symbol, the side, a price that is equal to or better than the national best bid orders, and a size that is equal to one round lot.
- The ATS trading volume threshold for displaying best priced orders on the tape would be lowered. Currently, ATSs that display orders to more than one person⁴ must display their best priced orders for a given stock when the average daily trading volume on the ATS is 5% or more.⁵ The SEC proposes lowering that threshold to .25%.
- The existing rules would be amended to require post-trade transparency comparable to that required of registered exchanges. The SEC currently identifies ATS trades as over-the-counter trades that need not be attributed to the executing ATS. The proposed amendments would require ATSs to provide real-time identification of the ATS when reporting executed trades.

All three proposals include an exemption meant to protect investors who rely on ATSs as the sole avenue for making large trades: the proposed regulations will not apply to IOIs involving orders of \$200,000 or more, so long as they are communicated only to those reasonably believed to represent comparable contra-side interest.

Reaction to the Proposals

The proposal is currently in the comment phase, and reactions to the proposed changes are mixed. Several commenters suggest that, rather than quashing dark pools, the new regulations will serve only to drive non-

¹ It is for this reason that dark pools have become useful for the execution of block trades as well as for the execution of at-the-market offerings.

² Regulation of Non-Public Trading Interest, Exchange Act Release No. 34-60997.

³ Proposed amendments to Rule 602, 17 CFR 242.602.

⁴ The SEC also proposed a minor amendment related to this requirement. The existing version of Regulation ATS requires ATSs to make certain disclosures when they display data to “more than one person in the alternative trading system.” 17 CFR 240.301(b)(3)(ii). The SEC seeks to replace the phrase “in the alternative trading system” with the phrase “(other than alternative trading system employees).” The rationale is that ATSs could too easily skirt the regulation by sending IOIs to parties who are “in” the ATS. The proposed amendment would eliminate this potential loophole.

⁵ Rule 301(b)(3), 17 CFR 242.301(b)(3).

reporting ATSS even further from public view. For example, the SEC's proposed rules will apply only to actionable IOIs; dark pools that rely solely on "pinging"—in which multiple dark pools route orders among one another to assess liquidity—would not be subject to the increased disclosure requirements. Another concern that has been raised is more philosophical: the U.S. trading landscape is highly competitive, with various marketplaces vying for investors' trading activity. If the SEC effectively bans one marketplace, there may be broader, unpredicted effects across the markets at large. More specifically, dark pools and other ATSS arose to accommodate investors needing to trade large blocks of stock, and are the market of choice for many investors in small- and mid-cap stocks. If the ATS market evaporates, where will those investors go? Finally, some commenters claim that, if protecting public exchanges is the animating principle, then the proposed regulations are unnecessary, or at the very least premature. Figures vary, but market participants estimate that dark pools account for somewhere between 7 and 10% of volume in the U.S. equity markets. It is not obvious, these commenters claim, that dark pools have enough of an impact at this time to warrant the new regulations.

The SEC's attention to dark pools comes in the midst of a proposed ban on flash orders and an expected concept release relating to high frequency trading strategies. While it is clear that the SEC envisions significant changes to the market structure, it is not yet apparent what shape those changes will take. Market participants would be wise to closely monitor these and other developments.

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