

SEC Proposes Additional Transparency for “Dark Pools” and Intends to Issue Additional Market Structure Proposals and Concept Release Soon

Summary

Taking another step in its review of equity market structure issues, on November 13, 2009, the Securities and Exchange Commission (the “SEC”) released a proposal to increase the transparency of “dark pools” of liquidity (Exchange Act Release No. 60997 (November 13, 2009)).

The term “dark pools” refers to non-exchange alternative trading systems (“ATs”) that do not display bids or offers in the public quote stream. The SEC’s proposal to increase the transparency of dark pools is a part of its broader market structure review, including its previously announced proposal to eliminate flash orders and an anticipated concept release regarding, among other things, all forms of dark liquidity, the order flow arrangements of over-the-counter (“OTC”) market makers and undisplayed orders on exchanges.

The dark pool proposal seeks to increase transparency and mitigate fragmentation by:

- treating actionable indications of interest (“IOIs”) as quotes;
- lowering the trading volume threshold at which an ATS is required to display its best-priced orders for a listed stock and provide nondiscriminatory access to such orders to non-subscribers from 5% to 0.25% of national trading volume in such stock; and
- requiring real-time disclosure of the identity of each ATS that executes a trade (today, the trades are reported generically as having been executed “over-the-counter”).

Each proposal would have an exception for block-size quotes or trades, as the case may be, as described below.

Dark pools that are “truly dark” – *i.e.*, do not display orders to more than one person – are not required to display orders under the proposed rules. Therefore, as the release states, the effect of the proposal is that “ATs could not privately display actionable IOIs only to select market participants and thereby create two-tiered access to information on the best available prices” for stocks.

Although an ATS will be required to provide access to its published quotes, the SEC did not propose to lower the trading volume threshold that triggers Regulation ATS’s requirement of “fair access” to an ATS’s full functionality. However, Senator Charles Schumer has sent a letter to SEC Chairman Mary Schapiro requesting that the SEC review whether the general fair access threshold should be lowered.

Brief History and Description of Dark Pools

In 1998, the SEC adopted Regulation ATS to encourage the development of innovative new market centers. Regulation ATS exempted “alternative trading systems” from registration as exchanges, but subjected them to certain core market-oriented obligations of exchanges when the particular ATS reached a certain size. In 2005, Regulation NMS was adopted to facilitate the development of an integrated national market system.

Since the adoption of Regulations ATS and NMS, ATS trading has grown significantly. The proposal states that OTC trading has reached approximately 38% of total market volume, including both ATS and other OTC trading. It also states that dark pool trading volume represented 7.2% of the total share

volume in listed stocks, as of the second quarter of 2009. However, most ATSS have not crossed the volume thresholds that trigger the public display of quotes. As a result, the SEC is concerned that the effectiveness and integrity of the public price discovery process could be harmed by the increasing trading in dark pools. In addition, the SEC is concerned that the proliferation of dark trading venues that do not quote publicly has increased market fragmentation – exactly what Regulation NMS was intended to avoid.

In response to these developments, the SEC's proposals aim to give greater visibility to quotes and trades of ATSS and indications of interest of all trading centers.

The Proposals

Actionable Indications of Interest

At present, the definition of “bid” or “offer” in Rule 600(b)(8) of Regulation NMS excludes “indications of interest.” The SEC has never defined IOIs, which has led to the use of IOIs that in many cases are indistinguishable from quotes. The SEC proposes to amend the definition of bid or offer to only exclude IOIs that are not actionable. Because the terms “bid” and “offer” are used in the definition of “order” in Rule 300(e) of Regulation ATS, actionable IOIs would be considered orders under Regulation ATS and therefore subject to the display requirement threshold described below, subject to an exception for IOIs of block size.

The term “actionable indication of interest” is not defined in the rule, although the SEC requested comment on whether it should be. Instead, the proposing release provides guidance on the factors the SEC considers relevant to determining whether an IOI is actionable. These factors include “the practical context” including explicit factors such as whether the IOI includes information regarding: (1) a particular symbol, (2) side (buy or sell), (3) size (e.g., minimum of a round lot of trading interest), and (4) price (e.g., equal to or better than the national best bid for buying interest and the national best offer for selling interest), and implicit factors such as the prior course of dealing between the parties. Essentially, the test is whether the IOI effectively represents a firm quote.

The SEC's proposal applies to the quote rule an interpretive position that was expressed over a decade ago in the Regulation ATS adopting release regarding firm orders. In that release, the SEC said: “The label put on an order – ‘firm’ or ‘not firm’ – is not dispositive. For example a system claiming it displays only ‘indications of interest’ that are not orders, may be covered by the new interpretation of ‘exchange’ if those indications are, in fact, firm in practice.” The SEC cited this language in the dark pool proposal and in its recent proposal to eliminate flash orders.

This proposal would amend the definitions of “bid” and “offer,” as they are used in the provisions of Regulation NMS, which specify the quoting obligations of certain exchange members, ATSS and OTC market makers. Therefore, the change would affect all persons subject to quoting obligations. It would not apply to block desks, because they are excluded from the definition of OTC market maker.

The proposal has an exception for IOIs of \$200,000 or more that are communicated only to those who are reasonably believed to represent current contra-side trading interest of equally large size. This is intended to avoid constraining IOIs used to find interest in large orders. It would apply equally to all users of IOIs, not just ATSS. However, it is not clear how an ATS or other user or transmitter of IOIs would satisfy the “reasonable belief” standard if this rule change is implemented.

While the release emphasizes the SEC's prior statements regarding firm orders, it appears to carefully avoid any statement that would require ATSS and other market centers to treat actionable IOIs as quotes pending adoption of the rule. Once adopted, however, we anticipate that the SEC will expect firms to comply rigorously with this interpretative position and will examine practices and potentially bring enforcement actions where practices veer from the spirit of the interpretation.

The release also states in a footnote that Rule 301(b)(10) of Regulation ATS “requires an ATS to establish adequate safeguards and procedures to protect subscribers’ confidential trading information” and that “[t]o meet this requirement, an ATS that markets itself as a dark pool, yet sends IOIs to third parties regarding subscriber orders, should adequately explain its use of IOIs to its subscribers.” With this statement, the SEC is warning dark pools that they must accurately describe their characteristics, and in particular the potential for information leakage resulting from their use of IOIs and similar trading techniques.

Public Display of Quotes

Rule 301(b)(3) of Regulation ATS requires any ATS to provide to an exchange or securities association for display in the public quote stream “the prices and sizes of the orders at the highest buy price and the lowest sell price” for any stock “displayed to more than one person” in the ATS if during at least 4 of the preceding 6 months the ATS had an average daily trading volume of 5 percent or more of the aggregate average daily share volume for such stock. The ATS is also required to provide broker-dealers the ability to execute against the displayed order equivalent to the ability to effect a transaction with other orders displayed on the exchange or association that displays the ATS’s order.

The SEC proposes to amend Rule 301(b)(3)(i)(B) to lower this threshold to 0.25%. The SEC believes that up to 12 ATSs (out of approximately 73 that are subject to Regulation ATS) could be impacted by the proposed rule. The release notes that many dark pools do not display quotes to more than one person, and therefore would not be affected by the revised threshold. The SEC also proposes to make a targeted amendment to Rule 301(b)(3)(ii) to make clear that the proposed display requirement is triggered if an ATS displays quotes to more than one person (other than employees of the ATS), irrespective of whether those persons are subscribers of the ATS.

As noted above, the SEC has not proposed lowering the threshold that triggers general fair access requirements below 5%, where it stands today. Therefore, an ATS that crosses the 0.25% display threshold would only be required to provide access to the particular quote that is displayed.

This proposal also provides an exception from the ATS quote requirement for quotes for \$200,000 or more communicated only to those who are reasonably believed to represent current contra-side trading interest of equally large size. Given the stated purpose of this exception to help find liquidity for large orders without having a market impact, it is curious that the SEC neither proposed nor sought comment on whether a similar exception from the quote rule should apply to exchanges and OTC market makers.

The SEC requested comment regarding, among other things, whether:

- the SEC should adopt a threshold based on additional or different criteria other than trading volume, such as adjusting the trading volume threshold based on the liquidity of a particular stock;
- ATSs that currently send actionable IOIs would choose to comply with the proposed amendments to Regulation ATS by submitting subscriber orders to an SRO for inclusion in the public quote stream or by going completely dark; and
- the proposed amendments provide greater incentives to initiate internalization programs in lieu of developing a new ATS.

Post-Trade Reporting

The third proposal is to amend the joint-industry plans for disseminating consolidated trade data to require real-time disclosure of “the identity of individual ATSs on trade reports in the public data stream, the same way exchange trades are identified.” Today, dark pool and ATS activity is recorded generically

as having occurred “over-the-counter.” As with the other proposals, block-size trades of \$200,000 or more would be excepted from this proposed requirement.

Among the SEC’s requests for comments is whether summary information, such as end-of-day identification of ATS volume statistics, would be preferable to real-time, trade-by-trade identification. The release specifically asks for comment on whether release of real-time identifying information would be detrimental to investors because of potential information leakage concerning customer orders.

The SEC does not propose to require the trades of OTC market makers to be individually identified, presumably on the belief that many of these trades are with customers and do not represent the prices at which the market maker would deal with non-customers.

Conclusion

The SEC’s proposal seeks to limit when dark pools can remain dark, as a first step in its broader review of equity market structure issues.

Certain constituencies will likely view these proposals as a modest beginning. For example, Senator Schumer has requested that the SEC take further action to regulate ATSS, including: requiring SEC approval to operate an ATS or to make material changes in an ATS’s operations, requiring ATSS to contribute and be subject to consolidated market surveillance, and eliminating the 20 percent volume threshold under Regulation ATS for triggering standards of systems reliability.

The next market structure items on the SEC’s agenda are the issuance of a concept release regarding dark liquidity generally, and possibly proposals regarding sponsored access, co-location, and high frequency trading, including a large trader-based registration requirement for high frequency traders.

There is a 90 day comment period after publication of the proposal in the Federal Register.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact

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