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Dark Pools Under SEC Spotlight

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At a n open meeting on October 21, 2009, the Securities and Exchange Commission (the "Commission" or "SEC") voted to publish for public comment three proposals that would significantly tighten the Commission's regulation of so-called "dark pools." Specifically, the proposals focus on "actionable indications of interest" ("IOIs"), a term acknowledged by SEC Commissioners as undefined in the rule proposals but that is generally described to include electronic messages containing enough information about underlying trading interest that they are functionally equivalent to quotations. Perhaps the most surprising aspect of the proposals is the proposed modification of the average daily trading volume threshold for the display of orders under Regulation ATS from 5% to 0.25%. Although a proposal to lower the threshold was not unexpected, the extent of the modification was not anticipated.[1]

The Commissioners acknowledged a number of advantages of dark pools, including lower trading costs, greater choice for market participants and increased competition among trading venues. They also noted that these benefits have accrued both to retail and institutional investors.

Notwithstanding these benefits, the Commission stated several reasons for its concern about actionable IOIs. First, because actionable IOIs are only transmitted to a select group of market participants–those with highly sophisticated trading systems–rather than public investors more generally, they have the potential to create a two-tiered market and raise fairness concerns more generally. Second, there is a concern that dark pools rely on the public quotations to price and execute IOIs, but do not contribute to price discovery in the public markets. Third, dark pools may siphon trading interest away from the public markets, thereby reducing the overall quality of public quotations.

The following discussion summarizes the three proposed rule changes relating to dark pools, as well as comments made and questions raised at the open meeting.[2] Once the Commission issues the proposing release, we anticipate publishing a more detailed overview of the proposals.

I. Description of Proposals

The Commission voted to issue three proposed rule changes related to dark pools. As a group, the proposals are designed to prevent the development of a two-tiered market by the use of actionable IOIs and provide more transparency and liquidity to the public market.

- The first proposal would amend the definition of a "bid" and "offer" for purposes of Rule 602 of the Securities Exchange Act of 1934[3] (the "Exchange Act") specifically to include actionable IOIs. If adopted, this amendment would apply to all trading venues, including alternative trading systems ("ATSs"). The amendment would include an exclusion for actionable IOIs for a quantity of stock with a market value of $200,000 or greater, if the actionable IOI is transmitted to a party reasonably believed to represent a viable contra-side for a transaction of such size (the "Block Size Exception").

- The second proposal, as noted above, would lower the average daily trading volume threshold in Rule 301(b)(3) of Regulation ATS[4] from 5% to 0.25%. As a result, ATSs, including dark pools that use actionable IOIs or otherwise display orders to more than one person (other than employees of the ATS) and that also meet the revised volume threshold for four of the preceding six months would be required to publicly display their best priced orders. Under the Display Rule, ATSs required to publicly display their best priced orders also are required to provide broker-dealers access to such orders on the exchange displaying them. This requirement would also be applicable at the lower volume threshold. The proposed amendment to the Display Rule would contain a Block Size Exception similar to that described above.

- The third proposal would require real-time disclosure of ATS trades, including the identity of any dark pool or other ATS that executes a trade. Currently, ATS trades are identified as over-the-counter trades and are not attributed to the executing ATS. As with the two other proposals, this proposal similarly includes a Block Size Exception.

II. Issues and Comments Raised at the Open Meeting

The Commissioners have expressed interest in receiving public comment on a wide range of issues including, for example:

- The effects that the growth of dark pools have had on trading patterns, including any supporting data.

- Whether, if adopted, the proposals would result in (1) more displayed liquidity or (2) dark pools becoming darker (*e.g.*, no longer transmitting IOIs).

- If dark pools were to become darker as a result of the adoption of the proposed rules, whether the rules would still yield benefits to the market.

- The types of trading activity that might develop as a result of determinations by dark pools to cease issuing actionable IOIs (*e.g.*, increased levels of pinging),[5] and whether any such changes would be beneficial for the market structure overall.

- Whether the description of actionable IOIs in the proposal would be sufficiently clear for market participants and SEC examiners since the proposals would not specifically define the term.

- Whether and how a market participant would be able to satisfy the requirements of the Block Size Exception and, in particular, how it would be able to demonstrate a reasonable belief that it sent an actionable IOI to a permissible contra-party under the exception.

- Whether in addition to the Block Size Exception, which is based on the market value of a large transaction ($200,000 or greater), there also should be an exclusion for orders of a certain share size, and whether either of these exclusions should be available to large orders that are broken into smaller orders.

- What the incentives are for smaller orders to be executed in dark pools and what this practice indicates about market structure.

- Whether fragmentation of dark pools is affecting the quality of the public market.

- Whether disclosure of trades executed in dark pools should be reported periodically, instead of in real-time, to avoid information leakage and the effects that real-time reporting would have on the market.

- Whether the Commission should refrain from taking action at this time and wait for publication of the anticipated concept release that will discuss market structure issues more generally.[6]

III. Next Steps

The dark pool proposals, which will have a 90-day comment period, clearly are the continuation of the recent resurgence of SEC–and Congressional–interest in market structure and trading issues. Earlier this month, the Commission issued a proposed rule that would ban marketable "flash orders."[7] In addition, the SEC staff is working on a concept release focusing on broader market structure issues. The Commissioners stated at the open meeting that the concept release will address high-frequency trading strategies, sponsored access and exchange co-location services designed to reduce execution speed latencies for market participants. Although the specific timing of the concept release was not discussed, the Commissioners indicated that it will be published in the not too distant future. Market participants interested in these issues should closely monitor developments with respect to all three planned releases.

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[1] The proposed threshold is significantly lower even than that urged by Senator Charles Schumer who, in a letter to SEC Chairman the day before the open meeting, called for a reduction of the threshold to 1%. *See* Letter from Charles Schumer, United States Senator, to Mary Schapiro,

Chairman, United States Securities and Exchange Commission (Oct. 20, 2009), available here.

[2] This Alert is not meant to serve as a verbatim memorialization of the open meeting, a webcast of which can be viewed here.

[3]*See* Exchange Act Rule 602, 17 CFR 242.602 (the "Quote Rule").

[4]*See* Exchange Act Rule 301(b)(3), 17 CFR 242.301(b)(3) (the "Display Rule").

[5] In general, pinging occurs when a dark pool routes an order to another dark pool to assess whether the dark pool has liquidity. *See* Erik R. Sirri, Director, SEC Division of Trading and Markets, Keynote Speech, SIFMA Dark Pools Symposium (Feb. 1, 2008) (referring to the floor of the NYSE as the largest dark pool), available here.

[6]*See* Part III of this Alert for a discussion of the concept release.

[7]*See* Exchange Act Release No. 60,484 (Sept. 17, 2009), 74 FR 48632 (Sept. 23, 2009), available here. Our Alert on the proposal to ban flash orders is available here.

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