

VIII. *Dark Pool Regulation*

A. Introduction

Over the last several decades, there has been an increase in the variety of trading venues available to market participants in the U.S. equity market.¹ One such venue is the “dark pool” alternative trading system (“ATS”).² A dark pool is an exchange in which traders purchase and sell assets without revealing their identities and without displaying transactions to the public.³ This arrangement minimizes price movements in the public market and allows participants to trade without alerting competitors to their actions.⁴ Broker-dealers operate dark pools, which means that dark pools are subject to the regulatory authority of the Financial Industry Regulatory Authority (“FINRA”),⁵ as well as the Securities and Exchange Commission (“SEC”).⁶

Dark pool trading has steadily increased in market share over the past five years.⁷ Dark pool trading accounted for roughly 4% of all security trading by volume in 2009 but had jumped to 13% by 2013.⁸ By one estimate, dark pool trading accounted for 37% of U.S. equities trading by volume during July of this year.⁹ Currently, over forty different dark pools operate in the United States, while there are

¹ Edward M. Eng, Ronald Frank & Esmeralda O. Lyn, *Finding Best Execution in the Dark: Market Fragmentation and the Rise of Dark Pools*, 12 J. INT’L BUS. & L. 39, 39 (2013).

² *Id.*

³ Aubrey Gallo, Development Article, *Dark Pool Liquidity*, 29 REV. BANKING & FIN. L. 88 (2009).

⁴ Christina Davilas, *New Dark Pool Regulation On the Horizon*, LAW360 (June 14, 2013, 11:51 AM), <http://www.law360.com/articles/450159/new-dark-pool-regulation-on-the-horizon>.

⁵ Scott Patterson, *‘Dark Pools’ Face Scrutiny*, WALL ST. J. (June 5, 2013, 9:55 PM), <http://online.wsj.com/article/SB10001424127887324069104578527361102049152.html>.

⁶ Davilas, *supra* note 4.

⁷ Patterson, *supra* note 5.

⁸ *Id.*

⁹ Jacob Bunge, *Market’s Dark Side Expands to More Than 3-Year High In July*, WALL ST. J. BLOG (July 31, 2013, 6:04 PM), <http://blogs.wsj.com/moneybeat/2013/07/31/stock-markets-dark-side-expands-to-more-than-3-year-high-in-july/?KEYWORDS=dark+poools>.

only 13 public exchanges.¹⁰ Dark pool trading has also reached record levels in Europe, exceeding 10% of European equities trading for the first time this past July.¹¹ As dark pool market share (and its concomitant market-wide influence) increases, so do the calls for regulation and oversight from regulators and industry leaders.¹²

Experts routinely disagree over whether dark pools positively or negatively impact the market.¹³ Traders argue that dark pools allow them to trade with minimal market impact,¹⁴ make it easier to execute large trade orders,¹⁵ make trading cheaper, and improve liquidity.¹⁶ Critics, on the other hand, argue that dark pools “reduce transparency, decrease liquidity . . . , impair price movement,”¹⁷ and create conflicts of interest among brokerages and exchanges that operate dark pools.¹⁸

This article reviews the recent developments in the regulation of dark pools. Part B briefly sketches the history of dark pool regulation in the United States and abroad. Next, Part C examines the motivation behind new calls for regulation of dark

¹⁰ Stephen Joyce, *SEC Contemplating Effects of Dark Pools As It Considers Market Structure Reforms*, 45 Sec. Reg. & L. Rep. (BNA) No. 45, at 768 (Apr. 29, 2013).

¹¹ Anish Puaar, *Financial News: Dark Pool Trading at Record Levels in Europe*, WALL ST. J. (Aug. 12, 2013, 3:33 AM), <http://online.wsj.com/article/BT-CO-20130812-701291.html>.

¹² Davilas, *supra* note 4.

¹³ *Compare Threats to Financial Markets Lurk in Dark Pools*, BLOOMBERG (June 20, 2013, 8:00 AM) <http://www.bloomberg.com/news/2013-06-20/threats-to-financial-markets-lurk-in-dark-pools.html> (“Evidence is mounting that trading in dark pools increases the odds that buyers and sellers won’t easily find each other, so investors can lose out on the best possible prices.”), with Haoxiang Zhu, *Do Dark Pools Harm Price Discovery?*, REV. FIN. STUD., (forthcoming), available at papers.ssrn.com/sol3/papers/cfm?abstract_id=1712173 (“Under certain conditions, adding a dark pool alongside an exchange concentrates price-relevant information into the exchange and improves price discovery.”).

¹⁴ Jacob Bunge, *FINRA Plan Would Shine Light on ‘Dark Pools’*, WALL ST. J. (July 12, 2013, 7:15 PM) <http://online.wsj.com/news/articles/SB10001424127887323740804578601784244525250>.

¹⁵ Eng, Frank & Lyn, *supra* note 1, at 45.

¹⁶ Joyce, *supra* note 10.

¹⁷ *Id.*

¹⁸ Jim Kim, *Morgan Stanley Makes Case Against Dark Pools*, FIERCEFINANCEIT (Apr. 8, 2011), <http://www.fiercefinanceit.com/story/morgan-stanley-makes-case-against-dark-pools/2011-04-08>.

pools, while Part D outlines some recent SEC proposals for dark pool regulation. Finally, Part E analyzes the recent FINRA proposal for new dark pool disclosure requirements that it submitted to the SEC for approval.

B. History of Dark Pool Regulation: Domestic and Foreign

Historically, U.S. authorities have acted slowly to regulate dark pools.¹⁹ Although dark pools first appeared in the early 1980s, the SEC regulated them for the first time in 1998 by enacting Regulation ATS, under which dark pools and any other ATS must register as broker-dealers.²⁰ Regulation ATS also mandates additional order display and execution access requirements for any ATS that exceeded “5% of the average daily trading volume” of a single stock.²¹ The SEC later enacted Regulation NMS in 2005, which was an effort to comprehensively overhaul the structure of the securities market by increasing disclosure requirements and decreasing fragmentation.²² Regulation NMS inadvertently encouraged traders to move to dark pools to avoid the increasing disclosure requirements on the public market.²³ Although the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 did not specifically address dark pool regulation, Congress intended the newly created Financial Stability Oversight Council to oversee companies that are systemically important financial institutions (“SIFIs”).²⁴ Some experts argue that dark pools may qualify as SIFIs and should be regulated by the Financial Stability Oversight Council.²⁵

While regulators in the United States are considering dark pool regulation, authorities in Canada and Australia have already addressed the issue.²⁶ In 2012, Canadian authorities introduced a

¹⁹ Davilas, *supra* note 4.

²⁰ *Id.*; see also 17 CFR § 242.301(b)(1) (2012).

²¹ Davilas, *supra* note 4.

²² *Id.*

²³ *Id.*; see also Gallo, *supra* note 3, at 93.

²⁴ Eng, Frank & Lyn, *supra* note 1, at 47.

²⁵ *Id.*

²⁶ John D’Antona Jr., *Mixed Reviews for Canadian ‘Trade At’*, TRADERS MAGAZINE (June 1, 2012) http://www.tradersmagazine.com/issues/25_338/trade-at-dark-pool-110076-1.html; George Lionidis, *ASIC Gets*

price improvement rule mandating that trades taking place in dark pools must “offer a meaningful price improvement over the displayed market’s price.”²⁷ The Australian Securities and Investment Commission also introduced comprehensive disclosure rules this year.²⁸ Although the experiences of Canada and Australia can give only limited guidance to United States regulators,²⁹ these new developments were a topic of discussion at an SEC meeting in April 2013.³⁰

C. New Calls for Regulation

Although dark pools were not one of the underlying causes of the 2008 financial crisis, they have nonetheless come under heightened scrutiny in recent years.³¹ Dark pools have become a popular scapegoat among proponents of Wall Street reform.³² Furthermore, dark pools are often associated with glitches in the electronic securities market and have attracted negative attention as a result.³³ Following several recent electronic trading glitches (most notably the “flash crash” of 2010), regulators have expressed a renewed interest in structural reforms of the private equity market.³⁴ One such glitch occurred on August 22, 2013, when NASDAQ shut down for three hours.³⁵ This incident prompted SEC Chairwoman Mary Jo White to address market structure and regulation generally at a meeting on September 12, 2013.³⁶ Chairwoman White

Tough on Dark Pool Activity, AUSTL. FIN. REV., Aug. 13, 2013, available at 2013 WLNR 19884138.

²⁷ D’Antona, *supra* note 26.

²⁸ Lionidis, *supra* note 26.

²⁹ Davilas, *supra* note 4.

³⁰ Joyce, *supra* note 10.

³¹ Eng, Frank & Lyn, *supra* note 1, at 47.

³² *Id.*

³³ *Id.*

³⁴ See generally CFTC & SEC, FINDINGS REGARDING THE MARKET EVENTS OF MAY 6, 2010: REPORT OF THE STAFFS OF THE CFTC AND SEC TO THE JOINT ADVISORY COMMITTEE ON EMERGING REGULATORY ISSUES (2010); Hazel Bradford, *Trading Problems Sparking Calls for Closer Oversight of Exchanges*, PENSIONS & INVESTMENTS, Sept. 2, 2013, available at <http://www.pionline.com/article/20130902/PRINT/309029976/trading-problems-sparking-calls-for-closer-oversight-of-exchanges>.

³⁵ Bradford, *supra* note 34.

³⁶ *Id.*

emphasized that a review of market structure is a priority³⁷ and that dark pools would be included in that review.³⁸

D. Current SEC Regulatory Proposals

There are several possible courses of action for the SEC should it decide to institute structural reforms of dark pools. One possible course of action is to implement a 2009 proposal to amend Regulation ATS and lower the “threshold that triggers order display and execution access requirements” from 5% to 0.25% of average daily trading volume.³⁹ Another option is a trade-at rule similar to the rule recently implemented by Canadian regulators.⁴⁰ Such a rule mandates that a stock traded in a dark pool must be sold for a price that is better than or equal to the price listed on the public market.⁴¹ Market participants have expressed doubt that the SEC would ever take such a drastic step because it would impact the ability of dark pools to compete with public exchanges.⁴² Dark pool operators also contend that a trade-at rule would “increase trading costs and make it more difficult for traders to fill and complete trading orders.”⁴³ Correspondingly, the New York Stock Exchange and other public exchanges support increased scrutiny of dark pools.⁴⁴ Any rule change will likely disrupt large broker-dealers that operate dark pools, such as Credit Suisse and Goldman Sachs.⁴⁵

Even without a formal rule change, the SEC has proven a willingness to prosecute dark pool operators for various violations, such as failing to provide the kind of anonymity and discretion that

³⁷ Emily Chasan, *Market Structure Issues on SEC's Front Burner*, WALL ST. J. BLOG (June 20, 2013, 5:01 PM), <http://blogs.wsj.com/riskandcompliance/2013/06/20/market-structure-issues-on-secs-front-burner/?KEYWORDS=dark+pools>.

³⁸ Bradford, *supra* note 34.

³⁹ Joyce, *supra* note 10.

⁴⁰ *See id.*

⁴¹ *Id.*

⁴² *Dark Pool Traders Say “Trade At” Rule Unlikely*, COMPLIANCE REP., Mar. 7, 2011, at 20.

⁴³ Joyce, *supra* note 10.

⁴⁴ Scott Patterson & Caitlin Nish, *FINRA Seeks to Shine Light on Dark Pools*, WALL ST. J. BLOG (May 22, 2013, 3:37 PM), <http://blogs.wsj.com/moneybeat/2013/05/22/FINRA-seeks-to-shine-light-on-dark-pools/>.

⁴⁵ Joyce, *supra* note 10.

traders expect.⁴⁶ The SEC did so for the first time in 2011 when it fined dark pool operator Pipeline Trading Systems LLC \$1 million for failing to disclose the extent to which one of its trading units operated.⁴⁷ In 2012, the SEC prosecuted another dark pool operator for sharing information about participants with an outside vendor when it had previously told participants that their trade information would be kept confidential.⁴⁸

E. FINRA Proposal

Any immediate change is most likely to come from FINRA, which submitted a new proposal to the SEC on September 30, 2013.⁴⁹ FINRA's latest proposal is the result of a detailed examination of dark pools that began in May 2013.⁵⁰ At that time, FINRA sent examination letters to dark pool operators in order to identify possible problematic or abusive practices in dark pools and learn more about the information that is shared with dark pool investors.⁵¹ The letters followed, and were possibly influenced by, an announcement in April 2013 by Credit Suisse Group AG that it planned to "stop providing information on its dark pool trading volume."⁵² Credit Suisse Group AG operates one of the biggest dark pools in the United States.⁵³ Recipients of the letters included Credit Suisse, Goldman Sachs, and Barclays.⁵⁴ The letters listed twelve

⁴⁶ Marc Dorfman & Ellen Wheeler, *Top Ten SEC Enforcement Developments of 2012*, 19 WORLD SEC. L. REP. (BNA) NO. 4, at 41 (Apr. 12, 2013).

⁴⁷ Bunge, *supra* note 14.

⁴⁸ Press Release, SEC, SEC Charges Boston-Based Dark Pool Operator for Failing to Protect Confidential Information (Oct. 3, 2012), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171485204#.Uj-7BZD3ww>.

⁴⁹ Proposed Rule to Require Alternative Trading Systems to Report Volume Information and Use Unique Market Participation Identifiers, Securities Act Release No. 34-70676, 78 Fed. Reg. 62,862, 62,862 (Oct. 22, 2013).

⁵⁰ Patterson, *supra* note 5.

⁵¹ *Id.*

⁵² Davilas, *supra* note 4.

⁵³ Patterson, *supra* note 5.

⁵⁴ *Id.*

questions pertaining to the structure of dark pools.⁵⁵ Among the more intrusive inquiries were requests for lists of the dark pools' "top 10 subscribers by executed share volume," descriptions of their surveillance methods, and the roles that any affiliates or third-parties in the trading process.⁵⁶

As a result of its inquiry into dark pools, FINRA announced in July 2013 that it would submit a proposal for a new set of disclosure requirements to the SEC.⁵⁷ FINRA did so at the end of September.⁵⁸ The proposed rules contain two main provisions. First, each ATS would be required to "report aggregate weekly volume of transactions and number of trades within the ATS by security."⁵⁹ FINRA would then report that data on its website on a "delayed basis,"⁶⁰ which would be either two or four weeks depending on the type of security.⁶¹ Second, it would "require[] that each ATS use a single, unique [market participation identifier] when reporting information to [FINRA]."⁶² These changes would allow FINRA to know which dark pool facilitated each particular trade.⁶³ The purpose of these rules is to "enhance [FINRA's] regulatory and automated surveillance efforts by enabling it to obtain more granular information regarding activity conducted" on ATSs and to make it

⁵⁵ *Targeted Examination Letters*, FINRA (May 2013), <http://www.FINRA.org/Industry/Regulation/Guidance/TargetedExaminationLetters/P268091>.

⁵⁶ *Id.*

⁵⁷ Nick Baker, *Dark Pools Face New U.S. Disclosure Requirements From Finra*, SECS. TECH. MONITOR (July 15, 2013), <http://www.securitiestechologymonitor.com/news/dark-pools-face-new-us-disclosure-requirements-from-finra-bloomberg-31814-1.html>.

⁵⁸ Proposed Rule to Require Alternative Trading Systems to Report Volume Information and Use Unique Market Participation Identifiers, Securities Act Release No. 34-70676, 78 Fed. Reg. 62,862, 62,862 (Oct. 22, 2013).

⁵⁹ *Id.* at 4.

⁶⁰ *Id.*

⁶¹ John D'Antona Jr., *Industry Execs OK with FINRA's New Dark Pool Rule Proposal*, TRADERS MAGAZINE (Oct. 3, 2013), <http://www.tradersmagazine.com/news/industry-execs-ok-with-finras-new-dark-pool-rule-proposal-111589-1.html>.

⁶² Proposed Rule to Require Alternative Trading Systems to Report Volume Information and Use Unique Market Participation Identifiers, Securities Act Release No. 34-70676, 78 Fed. Reg. at 62,862.

⁶³ Sam Mamudi, *Dark Pools Face New FINRA Disclosure Requirements*, BLOOMBERG (Oct. 1, 2013, 12:44 PM), <http://www.bloomberg.com/news/2013-10-01/dark-pools-face-new-FINRA-disclosure-requirements.html>.

easier for FINRA to know whether a dark pool exceeds certain thresholds in Regulation ATS that trigger certain regulatory requirements.⁶⁴ The new rules require SEC approval to become effective.⁶⁵ The SEC will likely authorize the rules in 2014.⁶⁶

In general, industry insiders welcome the new disclosure rules. Some dark pools already voluntarily provide this information to Rosenblatt Securities Inc., an agency brokerage that compiles data on dark pools.⁶⁷ Credit Suisse was among those self-reporting dark pool operators but ceased providing information because it believed that all dark pools should be subject to the same reporting requirements.⁶⁸ Dan Mathisson, Head of Equity Trading at Credit Suisse believes that FINRA's new proposal addresses Credit Suisse's desire for uniformity: "It would be healthy for the market for everyone to report volumes and have some reporting methodology," he said, adding, "[c]onsistent reporting criteria are key."⁶⁹ Others, such as Robert Felvinci, Head Trader at the investment firm Spinnaker Trust, are content with the new rules as long as they include a delay in reporting data to "protect against high-frequency trade operations in the market that are looking for opportunities to profit from this trading information."⁷⁰ With the FINRA proposal already submitted to the SEC, industry participants should plan for the new regulations and participate in the comment period if they would like to influence the rule change.⁷¹

⁶⁴ Proposed Rule to Require Alternative Trading Systems to Report Volume Information and Use Unique Market Participation Identifiers, Securities Act Release No. 34-70676, 78 Fed. Reg. at 62,862.

⁶⁵ Mamudi, *supra* note 63.

⁶⁶ John D'Antona Jr., *New Finra Dark Pool Rule Could Surface Next Month*, TRADERS MAGAZINE (Sept. 11, 2013), <http://www.tradersmagazine.com/news/new-finra-dark-pool-volume-rule-possible-october-111522-1.html>.

⁶⁷ Patterson & Nish, *supra* note 44.

⁶⁸ D'Antona, *supra* note 66.

⁶⁹ D'Antona, *supra* note 61.

⁷⁰ *Id.*

⁷¹ Davilas, *supra* note 4.

F. Conclusion

Over the past several years, regulators and industry experts have voiced their increased support for closer oversight of dark pools.⁷² Regulators cite the increased market share of dark pools, the financial crisis, and the recent glitches associated with high frequency trading as justifications for closer scrutiny of dark pools.⁷³ Some experts contend that dark pools are inherently detrimental to the securities market.⁷⁴ FINRA recently proposed a new set of disclosure requirements for dark pool operators, which the SEC is poised to approve.⁷⁵ These new requirements will allow FINRA and the SEC to monitor dark pool activities more closely by compiling and publishing data on dark pool activities on a delayed basis.⁷⁶ Dark pool operators generally support the proposal because it introduces uniform disclosure requirements and maintains a delay between trade execution and disclosure.⁷⁷ The SEC is expected to approve the proposal sometime in 2014.⁷⁸

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⁷² See *supra* notes 32–39 and accompanying text.

⁷³ *Id.*

⁷⁴ See *supra* notes 14–19 and accompanying text.

⁷⁵ See *supra* notes 58–68 and accompanying text.

⁷⁶ See *supra* notes 58–65 and accompanying text.

⁷⁷ See *supra* notes 69–78 and accompanying text.

⁷⁸ See *supra* notes 67–68 and accompanying text.

⁷⁹ Student, Boston University School of Law (J.D. 2015).