October 14, 2013

FINRA Proposes Rules to Illuminate "Dark Pools"

The Financial Industry Regulatory Authority (FINRA) filed a rule proposal with the Securities and Exchange Commission (SEC or the Commission) on September 30 that would impose reporting requirements on alternative trading systems (ATSs), including dark pools.[1] Dark pools are a type of ATS in which participants can transact their trades without displaying quotations to the public.[2] Pursuant to the proposed rules, each ATS must report its aggregate weekly volumes and number of trades on a security-by-security basis to FINRA and indicate which trades take place on ATS platforms. Although the proposed rules will not apply to off-exchange trading venues that are excluded from Regulation ATS requirements,[3] the rules, if approved by the SEC, will increase publicly available information about these opaque and rapidly growing private markets.

Alternative trading systems are threatening to supplant traditional exchanges. In a speech at the Security Traders Association's market structure conference on October 2, SEC Chair Mary Jo White stated that more than half of the orders of long-term investors are executed on off-exchange "dark" venues.[4] However, only limited data on ATSs is publicly available. Commercial sources, including Rosenblatt Securities and Tabb Group, provide subscription sources of information on ATS trading, but these sources rely on self-reported data, which is limited in scope.

Dark pools match up trades of buyers and sellers anonymously, thereby allowing investors to trade large blocks of securities without having news of their orders move the market. While historically dark pools were used by large institutional investors, the average trade size has been declining as hedge funds and high-frequency trading firms have started to migrate to these systems.

Dark pools have been on FINRA's radar since at least last fall, when the regulator issued examination letters to several operators of ATSs, seeking copies of policies and procedures, descriptions of the visibility of order information by clients, information about how each firm uses indications of interest, and data on error handling and complaints, among other information. Earlier this year, FINRA sent a second round of letters, seeking information on how ATSs operate, how they route orders, what they disclose to clients and how they police trades.

FINRA is proposing to adopt new FINRA Rule 4552, which will require each ATS to report volume information regarding transactions within the ATS in securities (both equity and debt), subject to FINRA reporting obligations. Each ATS will be required to report to FINRA the aggregate weekly volume of transactions and number of trades within the ATS by security, within seven business days after the end of each calendar week. FINRA proposes to post the reported information on its website regarding National Market System (NMS) stocks in the S&P 500 Index or the Russell 1000 Index and certain exchange-traded products on a two-week delayed basis. All other NMS stocks and over-the-counter equity securities subject to FINRA trade reporting requirements would be published on a four-week delayed basis, to minimize potential market impact.

In a webcast to FINRA members, Richard Ketchum, FINRA's chief executive, stated that the rules will enable FINRA to understand the amount of activity occurring in each ATS, thereby increasing information about ATS trading generally and dark pool trading in particular.[5]

The proposed rules will also require each ATS to use a unique market participant identifier (MPID) when reporting order or

trade information to FINRA. Under current FINRA rules, although each over-the-counter securities transaction in which an ATS is involved must be reported under FINRA rules, a broker-dealer operating an ATS may report trades executed within the ATS using the same MPID it uses for transactions in other areas of its business, making it impossible to determine from the trade reporting data which trades were executed on the ATS as opposed to other areas of the broker-dealer's business. Use of a unique MPID will permit FINRA to closely monitor for abusive conduct the trading that occurs in each ATS. Ketchum described the effort as "a real positive step from a market-integrity standpoint."[6]

Not surprisingly, the stock exchanges have requested that regulators curb trading in dark pools. Earlier this year, the chief executive officers of NYSE Euronext Inc., Nasdaq OMX Group Inc. and BATS Global Markets Inc. asked the SEC to pass a rule requiring brokers to route an order to an exchange unless they can improve on the best public quote by a defined amount.

FINRA is not alone in seeking more information about dark pool trading. As early as 2009, the SEC voted to propose measures "intended to increase transparency of dark pools so investors can get a clearer view of stock prices and liquidity."[7] In testimony before the Senate Banking Committee in March 2013, Mary Jo White noted that dark pools, among other technological developments, raise many questions, stating, "Do they result in unnecessary volatility, or create an uneven playing field? Or do these modern-day features bring benefits such as efficiency, price reduction, and healthy competition to our markets? Do they do all of these things? The experts and studies to date have not been consistent or definitive in their observations and findings about whether and to what extent harm is caused by the current market structure and practices."[8]

The SEC is seeking to answer these questions, and others, through more sophisticated data analysis. On October 9, the SEC announced that it was making a vast trove of data drawn from MIDAS, the SEC's market information and data analysis service, available on its website, to help inform the broader market structure debate.[9] The resources include a paper providing key metrics describing the underlying nature of off-exchange trading by the ATSs that trade equity securities, and a paper summarizing current studies addressing visible and dark market fragmentation.

By proposing rules requiring ATSs to report aggregate volume information and number of trades on a security-by-security basis and to obtain a unique MPID designed for exclusive use for reporting each ATS's transactions, FINRA is taking the first step toward increasing transparency in dark pools. We will continue to monitor this evolving area of regulation.

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[1] Regulation ATS defines an alternative trading system as "any organization, association, person, group of persons, or system: (1) That constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of [Exchange Act Rule 3b-16]; and (2) That does not: (i) Set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system; or (ii) Discipline subscribers other than by exclusion from trading." 17 C.F.R. ? 242.300(a). Although ATSs operate similar to traditional exchanges, they are regulated as broker-dealers rather than as national security exchanges. The proposed rule change applies to any alternative trading system, as that term is defined in Regulation ATS, that has filed a Form ATS with the Commission.

[2] Securities and Exchange Commission Press Release, SEC Issues Proposals to Shed Greater Light on Dark Pools, Oct. 21, 2009, available at http://www.sec.gov/news/press/2009/2009-223.htm (SEC Dark Pool Press Release).

[3] Regulation of Exchanges and Alternative Trading Systems, Final Rule, SEC Release No. 34-40760, 63 Fed. Reg. 70844 (Dec. 22, 1998).

[4] Mary Jo White, Chair, U.S. Securities and Exchange Commission, Address to Security Traders Association 80th Annual Market Structure Conference, Focusing on Fundamentals: The Path to Address Equity Market Structure (Oct. 2, 2013), available at http://www.sec.gov/News/Speech/Detail/Speech/1370539857459 (Mary Jo White STA Speech).

[5] FINRA, July 2013 Board Update, available at http://www.finra.org/Industry/Regulation/Guidance/.

[6] *Id.*

[7] SEC Dark Pool Press Release.

[8] Testimony of Mary Jo White, Nominee for Chair of the U.S. Securities and Exchange Commission Before the United States Senate Committee on Banking, Housing and Urban Affairs, Mar. 12, 2013, available at http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=619e5603-c2c8-4085-98c6-0014ce29bde7.

[9] Mary Jo White STA speech.