Essay

Reforming the Murky Depths of Wall Street: Putting the Spotlight on the Security and Exchange Commission's Regulatory Proposal Concerning Dark Pools of Liquidity

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"Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[1]

Introduction

When the Securities Act of 1933 and the Securities Exchange Act of 1934 were first drafted, President Roosevelt expected that they would establish an equitable market system primarily by requiring public companies to follow a strict regimen of disclosure to investors.[2] Considering New Deal rhetoric concerning light and sunshine, however, it is quite ironic that trading structures ominously referred to as

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1 Louis D. Brandeis, Other People's Money and How the Bankers Use It 92 (1914).

2 *See* Larry D. Soderquist & Theresa A. Gabaldon, Securities Regulation 2 (6th ed. 2006).

"dark pools of liquidity" now flourish in the nation's stock market system.[3]

Dark pools present important problems to the U.S. Securities and Exchange Commission ("SEC" or "Commission"), the government regulatory body tasked with providing investor protection and promulgating administrative rules that foster efficient capital formation.[4] Dark pools are trading venues that rely on innovative and sophisticated software.[5] To certain groups of investors, they allow for the efficient execution of trading strategies that can be immensely profitable.[6] In other respects, however, dark pools certainly deserve their shadowy-sounding name; they are a venue apart, failing to provide information that is available on public stock exchanges such as the NASDAQ or the New York Stock Exchange.[7] While the vast majority of stock trades continue to happen on "light venues" of this latter type, the influence of dark pools has grown steadily to include over seven percent of all U.S. stock trades.[8] Although the growth of dark pools was originally viewed with some measure of apathy by the SEC,[9] increased regulation of these venues now constitutes one of the major policy proposals of the recently appointed SEC Chairman, Mary Schapiro.[10]

On November 13, 2009, the SEC released a new rules proposal that could drastically change not only the workings of dark pools, but of other alternative stock trading venues that compete with national exchanges.[11] In explaining what these rules entail and commenting on their desirability, this Essay seeks to explain and evaluate how the SEC has addressed problems associated with one perceived regulatory loophole. Part I begins by providing an explanation of what dark pools are, how they have developed over time, and why they are

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3 According to the SEC, trading in dark pools accounted for 7.2% of the total U.S. trading volume in publicly traded stocks. *See* Regulation of Non-Public Trading Interest, 74 Fed. Reg. 61,208, 61,209 (proposed Nov. 13, 2009) (to be codified at 17 C.F.R. pt. 242) [hereinafter SEC Dark Pools Proposal], *available at* http://www.sec.gov/rules/proposed/2009/34-60997.pdf.

4 Securities Act of 1933, 15 U.S.C. § 77b(b) (2006); Securities and Exchange Act of 1934, 15 U.S.C. § 78c(f) (2006).

5 *See infra* Part I.

6 *See* Alexandra Zendrian, *Don't Be Afraid of the Dark Pools*, FORBES.COM, May 18, 2009, http://www.forbes.com/2009/05/18/dark-pools-trading-intelligent-investing-exchanges.html.

7 *See* SEC Dark Pools Proposal, *supra* note 3, at 61,208.

8 *See id.* at 61,209.

9 *See infra* Part II.

10 *See infra* Part III.

11 *See* SEC Dark Pools Proposal, *supra* note 3, at 61,235–38; Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Statement on Dark Pool Regulation Before the Commission Open Meeting (Oct. 21, 2009), *available at* http://sec.gov/news/speech/2009/spch102109mls.htm.

growing in popularity. Part II discusses the reactions of different segments of the finance community to dark pools of liquidity and gives a synopsis of different regulatory reactions that have been suggested to the Commission. Part III discusses the actual SEC proposal. Overall, if adopted, elements of the SEC proposal would shed beneficial light on certain processes that now occur in dark pools. Other items of the proposal, however, seem to have much less potential to create meaningful change. In essence, portions of the SEC proposal may represent an unnecessary smokescreen that may hurt the efficiency and competitiveness of U.S. financial markets.

I. The Background and Development of Dark Pools of Liquidity

In investment terminology, "liquidity" signifies the ease with which an asset can be bought or sold without substantial price variation.[12] Items are more liquid when an active market of both buyers and sellers exists.[13] Liquidity is said to be "dark" when the public at large does not generally know the interests of a buyer or seller.[14] Overall, the presence of dark liquidity in U.S. markets is not new.[15] Before automation, stock trades usually occurred after face-to-face bargaining. Although traders in the pit of the New York Stock Exchange were aware of the specific stock prices available to investors, such information was not published for the public at large.[16]

Today, however, public price statements, or quotes, are a ubiquitous component of securities trading.[17] In theory, public pricing is incredibly beneficial to investors, as it allows them to quickly compare available prices in order to find the best cost provider of a certain security.[18] Similarly, requiring quotes allows the seller of a security to choose the highest bidder among various options.[19]

In some circumstances, however, certain traders may wish to carry out transactions away from public view. The quintessential example is an affluent institutional buyer, such as a large investment

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12 BLACK'S LAW DICTIONARY 1015 (9th ed. 2009).

13 *See id.*

14 *See* SEC Dark Pools Proposal, *supra* note 3, at 61,208.

15 Erik R. Sirri, Dir., Div. of Trading and Mkts., U.S. Sec. & Exch. Comm'n, Keynote Speech at the SIFMA 2008 Dark Pools Symposium (Feb. 1, 2008), *available at* http://sec.gov/news/speech/2008/spch020108ers.htm.

16 *See id.*

17 *See, e.g.*, 17 C.F.R. § 242.603 (2009) (mandating public access to stock quotations).

18 Order Execution Obligations, Exchange Act Release No. 34-37619A, 61 Fed. Reg. 48,290, 48,293 (Sept. 12, 1996).

19 *See id.*

bank or retirement fund, that wishes to obtain a large amount of stock.[20] Other traders, noticing the increased demand for this certain security due to the institutional buyer's position, may begin to buy that stock as well, hoping that the first buyer is correct in believing that the security represents a good value.[21] Invariably, the attitude of some traders is slightly more insidious; they hope to buy up stock and then sell it to the institutional buyer at a profit.[22]

In order to thwart these types of front-running tactics, large institutional investors have an enormous interest in ensuring that their trading strategies remain secret for as long as possible.[23] The abilities of institutional investors to pursue such strategies, however, were dramatically curtailed by the SEC's passage of Regulation NMS in 2004.[24] Meant to increase the efficiency of the United States' national market system, Regulation NMS required registered national exchanges to aggregate[25] and publicize all quotations for each of the securities listed at their venues.[26] Furthermore, Regulation NMS mandated that broker-dealers acting on behalf of investors only execute trades at the best available price.[27] By this time, the SEC had also allowed stock prices to be listed in decimal increments of one cent as opposed to sixteenths of a dollar.[28] This allowed stock prices to move more freely and made it easier for stock traders to offer prices that were either slightly over or slightly under current market rates.[29]

Decimalization and the passage of Regulation NMS combined to dramatically decrease the amount of large block trades that occurred on large public exchanges. By one estimate, over sixty percent of the trading volume of the New York Stock Exchange in April 2001 in-

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20 SEC Dark Pools Proposal, *supra* note 3, at 61,209 n.4.

21 *See id.*

22 *See* Interview by Steve Forbes with Seth Merrin, CEO, Liquidnet (Feb. 16, 2009), *available at* http://www.forbes.com/2009/02/13/seth-merrin-transcript-intelligent-investing_0216_merrin.html.

23 SEC Dark Pools Proposal, *supra* note 3, at 61,208 n.4.

24 Regulation NMS—Regulation of the National Market System, 17 C.F.R. §§ 242.600–.612 (2009); Donald C. Langevoort, *U.S. Securities Regulation and Global Competition*, 3 VA. L. & BUS. REV. 191, 202–03 (2008).

25 17 C.F.R. § 242.603.

26 *Id.* § 242.610 (also known as the Order Access Rule).

27 *Id.* § 242.611 (also known as the Order Protection Rule).

28 *See* U.S. Sec. & Exch. Comm'n, Commission Notice: Decimals Implementation Plan for the Equities and Options Markets (July 24, 2000), *available at* http://www.sec.gov/rules/other/decimalp.htm.

29 David Bogoslaw, *Big Traders Dive into Dark Pools*, BUS. WEEK ONLINE, Oct. 3, 2007, http://www.businessweek.com/print/investor/content/oct2007/pi2007102_394204.htm.

volved block trades of ten thousand shares or more.[30] Five years later that level had dropped to eighteen percent.[31] Both Regulation NMS and the Securities Exchange Act of 1934 ("Exchange Act"),[32] however, did contain loopholes that allowed trades to happen in venues where price disclosure was not required.[33] Alternative Trading Systems ("ATS"), governed by section 5 of the Exchange Act[34] and Regulation ATS,[35] allowed trading to occur without the use of public quotes.[36]

As enacted in 1998, Regulation ATS proposed to allow a small amount of trading to occur in venues that were not subject to the strict regulatory requirements of section 6 of the Exchange Act.[37] Instead, an ATS could simply register as a broker-dealer under section 15 of the Exchange Act.[38] An ATS was not subject to Regulation NMS public quoting rules as long as its trading volume in a particular stock did not exceed five percent of the national trading volume in that stock.[39] This limit, adopted in an attempt to balance an ATS's desire to mitigate costs with the SEC's desire to integrate pricing into one national system,[40] was soon being tapped by Wall Street entrepreneurs as a source of dark liquidity.[41] ATSs that wanted to keep their transactions dark also benefitted from the trade reporting standards adopted by the Consolidated Tape Association ("CTA").[42] Although ATSs were required by the CTA to report the parties involved in the trades they had executed, such reporting could occur days or even

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30 *Id.*

31 *Id.*

32 Securities and Exchange Act of 1934, 15 U.S.C. §§ 78a–78mm (2006).

33 *See* 17 C.F.R. § 242.601 (2009) (requiring only national securities exchanges to make detailed reports of their quotes and transactions).

34 15 U.S.C. § 78e.

35 Regulation ATS—Alternative Trading Systems, 17 C.F.R. §§ 242.300–.303 (2009). Trading venues defined as "alternative trading systems" do not have to file reports under Regulation NMS. *See id.* § 242.601.

36 *See id.* § 242.601.

37 *See* Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70,844, 70,847 (Dec. 22, 1998).

38 17 C.F.R. § 242.301(b)(1).

39 *Id.* § 242.302(b)(5)(B).

40 *See* Regulation of Exchanges and Alternative Trading Systems, 63 Fed. Reg. at 70,847.

41 Keith Fitz-Gerald, *Are "Dark Pools" Destined to Be the Capital Markets' Next Black Hole?*, MONEYMORNING.COM, July 10, 2008, http://www.moneymorning.com/2008/07/10/dark-pools/.

42 The CTA is a self-regulatory organization. *See* SEC Dark Pools Proposal, *supra* note 3, at 61,218. Pursuant to Regulation NMS, the CTA has authority from the SEC to enact binding requirements that broker-dealers (including ATSs) must follow in reporting on the trades that they conduct. *See* 17 C.F.R. § 242.601.

weeks after the trade had been completed.[43] Furthermore, the CTA plan did not require an ATS to report when it had helped broker a transaction.[44]

To institutional traders looking to move securities without tipping their trading strategy to the public, dark pools created under Regulation ATS became the perfect solution. The five-percent threshold announced in Regulation ATS allowed dark pools to trade significant amounts of stock, while the reporting standards adopted by the CTA made it impossible to determine what trades were actually happening in the dark.[45] As new software was developed to handle orders, off-exchange trading became even more profitable for both investors and dark pool operators.[46] Operators could take a large order for stock and quickly divide it using computer algorithms.[47] Stock could be matched almost instantly with investors who had provided their stock for purchase. The automated features of most dark pool operations also made their per-share charges quite low.[48]

Business development from 2005 to 2008 proved that there was a ready market for purveyors of dark liquidity. By September 2007, an estimated forty dark pools existed.[49] Operators of dark pools, however, often encountered difficulties in finding willing counterparties for their customers' requested transactions.[50] This difficulty was the major reason behind two important developments in the realm of dark liquidity trading.

First, many dark pools sought liquidity by selectively lifting the lid off their holdings by providing certain investors with indications of interest ("IOI").[51] By offering IOIs, dark pools exploited a provision of Regulation NMS that specifically excluded IOIs as a type of bid or offer that needed to be reported publicly.[52] Although the information

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43 *See* SEC Dark Pools Proposal, *supra* note 3, at 61,218–20.

44 *See id.*

45 Peter Chapman, *Credit Suisse Lobbies for 'Fairer' Access to Dark Pools*, TRADERS MAG., June 13, 2008, http://www.tradersmagazine.com/news/101154-1.html.

46 Interview by Steve Forbes with Seth Merrin, *supra* note 22.

47 *See* Mary Lou Von Kaenel & Greg Malatestinic, *Do Black Swans Swim in Dark Pools?*, AUTOMATED TRADER, Second Quarter 2008, at 14, 15–16.

48 Bogoslaw, *supra* note 29 (mentioning the example of Liquidnet, a large dark liquidity provider that charges customers two cents per share to execute a trade).

49 *Id.*

50 *See* Peter Chapman & Nina Mehta, *2008 Review: IOIs Expand and Do More Heavy Lifting*, TRADERS MAG., Dec. 2008, at 56, *available at* http://www.tradersmagazine.com/issues/20_289/102773-1.html.

51 Zendrian, *supra* note 6.

52 17 C.F.R. § 242.600(b)(8) (2009).

included in an IOI varied widely throughout the industry, all IOIs served as notice that a dark pool was attempting to conduct a transaction involving a specific security.[53] IOIs did not always disclose whether the specific security was sought for purchase or sale or give the name of the investor involved, but IOIs usually did indicate that the price offered in the transaction was the same or better than the National Best Bid and Offer that was available on public exchanges.[54] For many dark pools, IOIs became a vital component in building the amount of trading liquidity they were able to offer.

Second, dark pool trading by large broker-dealers, who had ready access to securities by way of their customers, became extremely popular. After the passage of Regulation NMS, nearly all of Wall Street's major investment banks expanded their ability to conduct trades without using public exchanges.[55] Goldman Sachs, which had invested significantly in expanding the capacity of its information technology software and the precision of its trading algorithms, soon built the largest dark pool in the country, known as Sigma-X.[56] Merrill Lynch, Citigroup, and other major investing firms began to offer similar services.[57] By the summer of 2009, even the New York Stock Exchange announced a plan to enter into a partnership with Liquidnet, one of the country's largest independent dark pools.[58]

The sudden growth in the services offered by dark pools was startling to many observers of the finance industry.[59] Yet, initially, SEC regulators were unwilling to reform the regulations that allowed trading in dark pools, citing an absence of evidence that dark pools had an adverse impact on investors.[60] Regulators also noticed the difficulty in properly categorizing the many different types of nonpublic trading offered by the market.[61] Any reticence the SEC may have had in

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53 *See* Zendrian, *supra* note 6.

54 Chapman & Mehta, *supra* note 50, at 56.

55 Liz Peek, *'Dark Pools' Threaten Wall Street*, N.Y. SUN, Oct. 16, 2007, at 1, *available at* http://www.nysun.com/business/dark-pools-threaten-wall-street/64598/; Jonathan Spicer, *Bank-Run Dark Pools Swelling in U.S. Stock Markets*, REUTERS, June 3, 2009, http://www.reuters.com/article/domesticNews/idUSTRE5530IG20090604.

56 Peek, *supra* note 55.

57 *Id.*

58 Alexandra Zendrian, *NYSE Hearts Liquidnet*, FORBES.COM, June 8, 2009, http://www.forbes.com/2009/06/08/nyse-euronext-liquidnet-markets-dark-pools.html. This partnership is only one instance of many attempts by conventional trading platforms to give their customers more access to dark liquidity. *See, e.g.*, Jeremy Grant, *BATS Europe Reveals Plan for Dark Pool*, FIN. TIMES, June 29, 2009, at 20.

59 Fitz-Gerald, *supra* note 41.

60 *See* Peek, *supra* note 55, at 1.

61 *See* Sirri, *supra* note 15.

dealing with dark pools, however, soon dissipated when the Commission received strident calls to reform certain Wall Street practices in the aftermath of the economic panic of 2008.[62]

II. The Effects of Dark Pools and the Calls for Regulation

Beginning in 2007, analysts began to voice concerns about the growth of dark pools.[63] First and foremost, critics worried that by hiding information from the public at large, the activity in dark pools would harm the validity of public price quotes by making it difficult for investors to know if they were getting either the best price or the appropriate price for their transactions.[64] Second, critics worried that the lure of higher prices in dark pools would suck liquidity out of conventional exchanges, making it harder and more expensive for retail investors to conduct trades.[65]

Another of the critics' concerns focused on the ramifications of having a dark pool operated by large broker-dealer investment banks.[66] Currently, dark pools run by broker-dealers can access liquidity by using the firm's own trading desk.[67] Although the process is certainly efficient, critics worried that the process of trade internalization presented significant opportunities for self-dealing by allowing investment banks to intermingle their own holdings with orders made through their dark pools.[68]

The exigency of the dark pools issue was clouded, however, by disputes over how large their influence had grown in U.S. markets. One report predicted that, by 2011, thirty-eight percent of U.S. trades would occur in forums besides the national exchanges.[69] In a speech given in 2008, Erik Sirri, then the director of the SEC's Division of Trading and Markets, downplayed those projections, contending that dark pools' growth would eventually stabilize.[70] Another study by Rosenblatt Securities also supported the assertion that market de-

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62 *See infra* Part II.

63 *See, e.g.*, Chapman & Mehta, *supra* note 50, at 56; Peek, *supra* note 55.

64 *See* Fitz-Gerald, *supra* note 41; Peek, *supra* note 55, at 1.

65 *See* Fitz-Gerald, *supra* note 41.

66 *See* Peek, *supra* note 55, at 1; Tyler Durden, *Goldman Now Dominating Dark Pool Trading; Who Is Sigma X?*, posting to Zero Hedge (June 7, 2009, 12:52 PM), http://zerohedge.blogspot.com/2009/06/goldman-now-dominating-dark-pool.html.

67 Spicer, *supra* note 55.

68 *Id.* One Canadian bank officer noted that there would be "instant vilification from the rest of the public" if a Canadian ever sought to launch a dark pool. *Id.*

69 Darla Mercado, *Exchanges Could Drown in Dark Pools*, INVESTMENT NEWS, Sept. 12, 2007, http://www.investmentnews.com/article/20070912/REG/70912008.

70 Sirri, *supra* note 15. Sirri admitted that a large percentage of trade volume had shifted

mand would limit dark pool trading to a finite percentage of the overall market.[71] Certain Wall Street executives also noted that reports about dark pool activity might be overstated because dark pools themselves had reasons to exaggerate their trading volume as a way of attracting liquidity.[72]

Though Sirri's speech in early 2008 indicated that the SEC would take a wait-and-see approach regarding dark pools,[73] events would soon combine to alter the Commission's perspective. By the fall of 2008, the United States was struggling with perhaps the worst financial collapse since the Great Depression.[74] Arguably, the collapse was caused by Wall Street's exploitation of certain regulatory loopholes involving derivatives trading and credit-default swaps.[75] Another bombshell hit the SEC in December 2008, when financier Bernard Madoff confessed to a Ponzi scheme that had defrauded investors out of billions of dollars.[76] In view of both the economic downturn and the Madoff affair, Congress began pressuring the SEC to take a harder look at some of the freewheeling activities that were taking place on Wall Street.[77]

By the beginning of 2009, the SEC had a new chairman, Mary Schapiro, who was eager to plug any regulatory holes that might present a danger to the securities marketplace. In a speech given in June 2009, Schapiro laid out four areas that she had targeted for reform,

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from traditional exchanges, but he believed a large majority of those trades were now conducted on public electronic exchanges, as opposed to dark pool venues. *Id.*

71 Spicer, *supra* note 55. This report projected that overall market share of dark pools would stay at about nine percent. *Id.*

72 "The volume in the dark pools is very overstated. There are a lot of issues with people claiming volume where there isn't." Darla Mercado, *Exec Claims Dark-Pool Volumes Are Hyped*, INVESTMENT NEWS, May 6, 2008, http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20080506/REG/111847616/-1/BreakingNews04 (quoting Andrew Silverman, Managing Director of Morgan Stanley). Silverman estimated that, at that time, dark pool volume comprised 5–9% of U.S. equity trades, not the 10–20% that many analysts believed. *Id.*

73 *See* Sirri, *supra* note 15.

74 *See, e.g.*, Heather Stewart, *IMF Says US Crisis Is "Largest Financial Shock Since Great Depression,"* THE GUARDIAN, Apr. 9, 2008, http://www.guardian.co.uk/business/2008/apr/09/useconomy.subprimecrisis.

75 Kevin McCoy, *SEC Chief Urges Oversight of Credit-Default Swaps*, USA TODAY, Sept. 26, 2008, at 2B; John Poirier & Rachelle Younglai, *U.S. Regulators Ready Laws for OTC Derivatives Crackdown*, REUTERS, June 10, 2009, http://www.reuters.com/article/ousiv/idUSTRE55A0LK20090611.

76 *See* OFFICE OF INVESTIGATIONS, U.S. SEC, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME 1 (2009), *available at* http://www.sec.gov/news/studies/2009/oig-509.pdf.

77 *See, e.g.*, McCoy, *supra* note 75, at 2B.

including the issue of dark pools.[78] Schapiro noted that she was directing her staff to investigate if more regulations were warranted "to respond to the potential investor protection and market integrity concerns raised by dark pools."[79] Schapiro's comments clearly echoed statements by James Brigagliano, who was Erik Sirri's successor in directing the Commission's Division of Trading and Markets. Both Brigagliano and Schapiro expressed their concern over dark pools' uses of pretrade IOIs.[80] Considering the speed at which orders could be routed, Brigagliano noted that IOIs were "functionally and economically similar to public quotes."[81] The problem, however, was that the public did not have access to these order messages, creating a system that potentially excluded certain investors from vital information about certain market transactions.[82]

The SEC was already under significant pressure to avoid the image of a two-tiered system in the securities trading market. Senator Charles Schumer was particularly outspoken in calling for a ban on "flash orders," a service offered on public trading venues that allowed certain customers to see quotes milliseconds before they were posted publicly.[83] The similarity between flash orders and IOIs was not lost on Schumer, who soon called for the Commission to enact tighter regulations on dark pools.[84]

Several other high-profile events during the summer of 2009 did not implicate dark pools specifically, but did raise questions about the capabilities and possible dangers of the high-speed trading software that dark pools relied on. First, on July 3, Goldman Sachs alerted the

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78 Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Address Before the New York Financial Writers' Association Annual Awards Dinner (June 18, 2009), *available at* http://www.sec.gov/news/speech/2009/spch061809mls-2.htm. The other areas of emphasis that Schapiro mentioned were target date funds, municipal securities, and the fiduciary duties of investment advisors. *Id.*

79 *Id.*

80 *See id.*; *see also* James A. Brigagliano, Co-Acting Dir., Div. of Trading and Mkts., U.S. Sec. & Exch. Comm'n, Keynote Address to the 2009 SIFMA Market Structure Conference (May 20, 2009), *available at* http://www.sec.gov/news/speech/2009/spch052009jab.htm.

81 *Id.*

82 *See id.*

83 *See* Letter from Charles E. Schumer, U.S. Senator, to Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n (July 24, 2009), *available at* http://schumer.senate.gov/new_website/record.cfm?id=316252. The Commission responded to the Senator's request by proposing rules to ban all flash orders. Press Release, U.S. Sec. & Exch. Comm'n, SEC Proposes Flash Order Ban (Sept. 17, 2009), *available at* http://www.sec.gov/news/press/2009/2009-201.htm.

84 Nina Mehta, *Schumer and Niederauer Call for Greater Dark Pool Scrutiny*, TRADERS MAG., Oct. 20, 2009, http://www.tradersmagazine.com/news/schumer-niederauer-dark-pools-104523-1.html.

Justice Department that one of its software engineers had stolen portions of its computerized stock and commodities trading system.[85] After the suspect was apprehended, the prosecutor stated that Goldman had warned them that there was "a danger that somebody who knew how to use [the] program could use it to manipulate markets in unfair ways."[86] That same month, the Commodities Futures Trading Commission filed a lawsuit, also alleging that an advanced software program had been used in a fraud scheme to manipulate market prices.[87] These allegations stoked the fears of bloggers and conspiracy theorists, who were already accusing market insiders of manipulating high-speed trades and dark liquidity transactions to achieve unfair gains.[88]

Some of dark liquidity's most virulent critics were not investors concerned with transparency, but public stock exchanges concerned with maintaining their market share. Even as NYSE Euronext was attempting to strengthen its link with alternative providers of liquidity, including dark pools, its chief executive, Duncan Niederauer, issued statements in conjunction with Senator Schumer calling for reform.[89] Bob Griefeld, the president and CEO of NASDAQ, was less diplomatic, asking the SEC "to eliminate any order types or market structure policies that do not contribute to public price formation and market transparency."[90]

The reaction by operators of dark pools to this onslaught of criticism was measured. Most admitted that reform in certain areas would be necessary.[91] Some dark pool executives, however, were fearful that their industry would fall prey to a debilitating and unnecessary regulatory reaction.[92] Though they were open to some administrative tink-

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85 Jonathan Weil, *Goldman Sachs Loses Grip on Its Doomsday Machine*, BLOOMBERG NEWS, July 9, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aFeyqdzYcizc.

86 *Id.*

87 *See* Landon Thomas Jr., *Inquiry Stokes Unease over Trading Firms that Shape Market*, N.Y. TIMES, Sept. 4, 2009, at B1.

88 *See* Durden, *supra* note 66; *see also* Joe Hagan, *The Dow Zero Insurgency*, N.Y. MAG., Oct. 5, 2009, at 30, 32, *available at* http://nymag.com/guides/money/2009/59457/ (discussing the blogging efforts of Dan Ivandjiiski and the influence of his postings on Zero Hedge).

89 Jacob Bunge, *NYSE Teams with Dark Pools to Boost Transparency*, MARKETWATCH, Oct. 20, 2009, http://www.marketwatch.com/story/nyse-teams-with-dark-pools-to-boost-transparency-2009-10-20; Mehta, *supra* note 84.

90 Letter from Robert Greifeld, President & CEO, NASDAQ, to Mary Schapiro, Chairman, U.S. Sec. & Exch. Comm'n (July 27, 2009) (on file with author).

91 Geoffrey Rogow & Jacob Bunge, *Dark Pools Fire Back at Call for Ban*, WALL ST. J. ONLINE, July 31, 2009, http://online.wsj.com/article/ SB124906083065697257.html ("In interviews with nearly a dozen dark-pool executives, none objected to the SEC's initiative. Dark-pool administrators are willing to provide more transparency and standardize volume reporting . . . .").

92 Seth Merrin, the CEO of Liquidnet, one of the nation's large independent dark pools,

ering, supporters of dark pools vehemently defended the importance of market diversity and the right of market investors to selectively use dark liquidity in order to trade more efficiently.[93]

It was up to the SEC to pass judgment on the merits of having dark pools in U.S. markets. Moving relatively quickly, the Commission proposed certain new rules, which were published in the *Federal Register* on November 23, 2009.[94] The proposal did not call for a complete ban on dark pool trading, but it did propose limits that will certainly prove to be controversial, and perhaps even detrimental, if eventually enacted.[95]

III. Analyzing the SEC Proposal: The Good, the Bad, and What Might Be Missing

The SEC's proposal contains three main components. First, it recommends that all actionable IOIs with a value under $200,000 be subject to the same disclosure requirements as quotes posted on national exchanges.[96] Second, the SEC proposes to lower the trading threshold at which a dark pool must display its best price to the public from 5% of the average daily outstanding stock to 0.25%, again, excluding trades that were valued at more than $200,000.[97] Finally, the SEC proposes an increase in the post-trade transparency of dark pool trades, mandating the release of information about such trades in real time and identification of the specific dark pool that facilitated the transaction, as long as the trade has a value that is less than $200,000.[98]

A. Demanding More Transparency

As it stands, the third component of the SEC's proposed change, requiring dark pools to report post-trade information, would likely have little to no effect on their current business model.[99] This new

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has cautioned that "[i]f they do something that makes the dark pool light and eliminates the reasons for institutions to trade on our vehicles, that would be a disaster for a hundred million people out there." Jonathan Spicer, *SEC Spotlight Puts "Dark Pool" Venues on Defensive*, REUTERS, June 19, 2009, http://www.reuters.com/article/idUSN1946216120090619.

93 "'Undisplayed liquidity adds to execution quality. . . . You can come up with all kinds of anecdotes, but the simple fact is, on behalf of all investors, dark liquidity adds to execution.'" Rogow & Bunge, *supra* note 91 (quoting Bob Gasser, CEO of Investment Technology Group); *see also* Zendrian, *supra* note 6.

94 *See* SEC Dark Pools Proposal, *supra* note 3.

95 *See id.*

96 *Id.* at 61,209–10.

97 *Id.* at 61,210, 61,213.

98 *Id.* at 61,210, 61,236–37.

99 *See* Brigagliano, *supra* note 80.

rule would not only require many trades by dark pools to be posted to the consolidated trading tape immediately, but would also give each dark pool an identifier that would be published along with the trade.[100] Dark pools attract customers with the promise of keeping a client's position secret when they either wish to buy or sell a large amount of stock.[101] Once a dark pool has either acquired or sold the required shares, the risk of market movement based on the investor's position no longer exists.[102] Considering that many dark pool executives have already voiced support for regulatory standards concerning volume reporting, it is quite likely that this part of the SEC's proposal will be generally accepted by the industry.[103] Having reporting standards would be especially helpful to institutional investors who wish to see what types of liquidity dark pools are able to obtain and to monitor the speed of their transactions.[104] It would also allow regulators to more easily monitor dark pools to ensure that they are meeting their obligations to stay below established trading thresholds.[105] The fact that information concerning dark pool trades would hit the market more quickly would also help assuage concerns that dark pool activity invariably causes a latent disconnect between the market value and the fair value of a certain security.

B. A (Flawed?) Attempt at Draining Dark Liquidity

The SEC proposal makes clear that the Commission is not content simply to mandate post-trade transparency in the dark pool market. In moves that would be more drastic, the proposal also limits the size of orders that dark pools can process and the tools they can use to seek liquidity for their customers.[106]

The SEC's proposal to lower the volume trading threshold at which ATSs must make their quotes public is particularly surprising. Though it was rumored that the Commission was considering lowering the threshold, most commentators thought that any proposal would

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100 *See* SEC Dark Pools Proposal, *supra* note 3, at 61,219.

101 *See id.* at 61,208 n.4.

102 *See id.*

103 *See* Mercado, *supra* note 72; Rogow & Bunge, *supra* note 91. Dark pool operators will further find the new disclosure rule palatable because it would not require immediate disclosure for trades executed at the cost of $200,000 or more. SEC Dark Pools Proposal, *supra* note 3, at 61,220.

104 *See* SEC Dark Pools Proposal, *supra* note 3, at 61,232.

105 *See* Chapman, *supra* note 45 (noting how lax reporting rules made access rules under Regulation ATS "weak and unenforceable").

106 SEC Dark Pools Proposal, *supra* note 3, at 61,209–10.

place it at a level between 1% and 2%.[107] By proposing that this level be decreased to only 0.25%, a ninety-five percent reduction from its earlier level, the SEC seems to have accepted the premise that the amount of dark liquidity available to individual ATSs should be severely restricted.[108]

This stance has drawn considerable pushback from some significant players in the financial community.[109] Currently, dark pools operated by Goldman Sachs, Credit Suisse, and Getco trade at volumes that exceed one percent of the consolidated trading that occurs in U.S. securities markets.[110] Because it would be cumbersome and inefficient to constantly check the liquidity levels in each separate security with national averages, the proposed rule would certainly end much of the business that is currently routed through the larger dark exchanges.[111] Considering the ample income created by dark trading to certain investment firms such as Goldman Sachs, these companies are asking the Commission to modify its proposal.[112]

Defenders of a higher trading threshold argue that the proposal would still allow dark pools to route offers and orders to other dark pools.[113] Considering that their business depends on keeping price quotes hidden, many dark pool operators would probably prefer such an approach if their trading volume were near the threshold limit for a certain security.[114] Also, "'[t]here is nothing stopping dark pool operators from running multiple dark pools.'"[115] Seen from this perspective, the SEC's proposal does not amount to a draining of dark

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107 Nina Mehta, *Reg ATS 5% Threshold Could Get Lowered*, TRADERS MAG., Aug. 14, 2009, http://www.tradersmagazine.com/news/sec-reg-ats-display-fair-access-five-percent-104254-1.html.

108 SEC Dark Pools Proposal, *supra* note 3, at 61,215.

109 *See* Mehta, *supra* note 107.

110 *Id.*

111 Chapman, *supra* note 45. "'You can't run a line to somebody for one month for one security . . . . When they envisioned that rule it was in the days of the telephone. But nowadays there is [more] connectivity required.'" *Id.* (quoting Dan Mathisson of Credit Suisse).

112 *See, e.g.*, Letter from William P. Neuberger and Andrew F. Silverman, Managing Dirs., Morgan Stanley Elec. Trading, to U.S. Sec. & Exch. Comm'n 6 (Mar. 4, 2010), *available at* http://sec.gov/comments/s7-27-09/s72709-74.pdf; Letter from Greg Tusar, Managing Dir., Goldman Sachs Execution & Clearing, L.P., and Matthew Lavicka, Managing Dir., Goldman Sachs & Co., to U.S. Sec. & Exch. Comm'n 3 (Feb. 17, 2010), *available at* http://sec.gov/comments/s7-27-09/s72709-48.pdf (suggesting a one-percent threshold).

113 *See* Rachelle Younglai, *SEC Proposes to Shed Light on "Dark Pools,"* REUTERS, Oct. 21, 2009, http://www.reuters.com/article/idUSTRE59K50K20091021; Letter from William P. Neuberger and Andrew F. Silverman to U.S. Sec. & Exch. Comm'n, *supra* note 112, at 3–4.

114 *See* Younglai, *supra* note 113.

115 *Id.* (quoting Adam Sussman, director of research for TABB Group Consultants).

liquidity, but will merely sprinkle it to a larger number of venues. Fragmentation in the dark pools market will probably increase cost for investors looking for available dark liquidity.[116] Furthermore, having a larger number of dark pools, each possibly quoting a separate price for the same security, might exacerbate concerns about the validity of public pricing.[117]

The proposed change to the ATS stock threshold rule may also be troubling because it represents a dramatic shift in SEC policy, inasmuch as it can be construed as an attempt to drive trades from dark pools onto public quoting venues.[118] In 2008, Erik Sirri stated, with some humility, that "[a]ttempting to force market participants to display their trading interest when they do not wish to do so would be both fruitless and counter-productive."[119] Indeed, it may be that by leaving dark pools the option of routing excess orders, the Commission continues to recognize that extreme limits on the use of dark liquidity would cause investment capital to leave the U.S. market.[120]

However, considering that the proposed ATS threshold reduction seems primed to cause a dramatic fragmentation in the U.S. dark pools market,[121] passage of the rule would be unjustified in the absence of evidence that larger dark pools, as opposed to smaller operations, pose a threat to U.S. markets.[122] Although future findings by the SEC may provide such evidence, there seems to be little procedural difference between having large dark pools consummate nine percent of U.S. stock trades as opposed to having many smaller dark

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116 *See* Sirri, *supra* note 15 (discussing the effects of dark pool fragmentation).

117 A possible manifestation of this problem might exist if small investors begin to submit bids to dark pools that diverge from the best public quote available on the off chance that they may be accepted. *See* Zendrian, *supra* note 6 (dark pool executive suggesting the benefits of this course of action).

118 Erik Sirri stated strongly that it was not the Commission's duty to ban investing using dark pools. Sirri, *supra* note 15 ("A common misunderstanding of the Commission's approach to price transparency is that it requires the display of liquidity and thereby drives trading off the public markets. This is not true.").

119 *Id.*

120 *See* Langevoort, *supra* note 24, at 203–04.

121 For example, it would take five to six dark pools traded at the proposed level to complete the current amount of trading activity that occurs on Sigma-X, the dark pool operated by Goldman Sachs. *See* Mehta, *supra* note 107.

122 At least one industry consultant, TABB Group, has concluded that there is no evidence that dark pool volume should be curtailed. Younglai, *supra* note 113; *see also* Letter from Larry Tabb, Founder & CEO, TABB Group, to U.S. Sec. & Exch. Comm'n 4 (Dec. 8, 2009), *available at* http://sec.gov/comments/s7-27-09/s72709-21.pdf (comment letter in response to the SEC dark pools proposal).

pools linked by software consummating nine percent of all U.S. trades.[123]

C. Putting a Spotlight on IOIs

The SEC's attempt to force dark pools to make the content of automated IOIs public will probably generate the most comments to the Commission because of the enormous variability in how IOIs are used across the industry.[124] Arguments in favor of IOIs focus on their ability to create market matches more quickly, which allows for the more orderly flow of investment capital.[125] Considering that many of the institutions that use dark pools are mutual and pension funds, which represent the interests of thousands of individual investors, defenders of IOIs argue that their continued use actually benefits the public interest.[126]

The SEC's attitude in making IOIs public is probably encapsulated best by a recent statement by James Brigagliano: "When it comes to managing financial risks, there truly is no substitute for financial products traded in transparent markets capable of generating price discovery that properly incorporates the risk of those products."[127]

It is unclear, however, if the SEC's drive to restrict the use of IOIs goes too far,[128] especially because its current proposal would already ensure post-trade transparency of dark pool transactions. Investors who want to use dark liquidity will continue to argue that they should have the freedom to seek it, especially if they are willing to pay a premium for its use. Arguably, it is unfair and improper for the SEC

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123 One resulting difference would be increased routing costs to customers, who would presumably have to pay for the multiple organizations involved in completing their trade.

124 *See* Zendrian, *supra* note 6 (noting that while IOIs increase trade liquidity, they can also be used to manipulate the market); Letter from Leonard J. Amoruso, Gen. Counsel, Knight Capital Group, to U.S. Sec. & Exch. Comm'n 3–4 (Feb. 24, 2010), *available at* http://sec.gov/comments/s7-27-09/s72709-68.pdf (example of one of the many comment letters the SEC has received regarding IOIs).

125 *See* Zendrian, *supra* note 6; Letter from Leonard J. Amoruso to U.S. Sec. & Exch. Comm'n, *supra* note 124.

126 *See* Rogow & Bunge, *supra* note 91.

127 Brigagliano, *supra* note 80; *see also* SEC Dark Pools Proposal, *supra* note 3, at 61,208, 61,211.

128 Part of this lack of clarity stems from the fact that the SEC proposal does not define specifically what types of IOIs are actionable or forced to be made public. *See* SEC Dark Pools Proposal, *supra* note 3, at 61,212–13.

to take a position on IOIs that is clearly detrimental to the interests of institutional investors.[129]

Dark pools will also argue that they have an interest in keeping IOIs from being abused. Currently, there are risks that those who receive IOIs will use them to attempt to discover the current positions of dark pool users in order to game a profit.[130] Dark pools, however, would certainly lose clients if they allow orders to be handled in a way that allows institutional investors to be taken advantage of. Furthermore, the Financial Industry Regulatory Authority ("FINRA") has already ruled that dark pool operators face sanctions if they transmit fraudulent or misleading information in IOI messages.[131]

D. Work Left to Do? The Merits of Greater Disclosure to Investors

As much as the SEC proposal seems to allow outsiders to peer into the pretrade activities of dark pools, it does not give much information to consumers who are thinking about using dark pools to trade. Although staunch disclosure requirements form the bulwark of the SEC's regulation of national exchanges, the Commission, at this point, seems disinclined to treat dark pools and other ATSs under the same regimen. Currently, the process for becoming a national exchange under section 6 of the Exchange Act usually takes years and includes submitting detailed information about how bids are accepted and how trades are processed.[132] Drafts of these rules must be submitted to the SEC and are then posted online for public comment and response.[133] Having an involved process in the formation of these

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129 *See* Langevoort, *supra* note 24, at 202–04.

130 Zendrian, *supra* note 6.

131 *See* FIN. INDUS. REGULATORY AUTH., REGULATORY NOTICE 09-29, ORIGINATION AND CIRCULATION OF RUMORS (2009), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118807.pdf. FINRA is a self-regulatory organization that is tasked with creating and implementing standards to ensure fairness in trading markets. *See* Carrie Johnson, *SEC Approves One Watchdog for Brokers Big and Small*, WASH. POST, July 27, 2007, at D2.

132 For example, it took the NASDAQ five years to gain SEC approval to become a national securities exchange. *Compare* The Nasdaq Stock Market, Inc., Notice of Filing Application for Registration as a National Securities Exchange, Exchange Act Release No. 34-44396, 66 Fed. Reg. 31,952 (June 7, 2001), *available at* http://www.sec.gov/rules/other/34-44396.htm (indicating that NASDAQ submitted its application to become a national securities exchange to the SEC on Mar. 15, 2001), *with* Press Release, NASDAQ OMX, SEC Approves NASDAQ's Exchange Registration Application (Jan. 16, 2006), *available at* http://ir.nasdaqomx.com/releasedetail.cfm?ReleaseID=184424 (announcing the SEC's approval of the NASDAQ on January 16, 2006).

133 *See, e.g.*, SEC Release No. 34-44396, *supra* note 132, at 31,953.

rules leads to greater accountability and helps ensure that the exchange will be engaged in practices that are beneficial to the investor.

Currently, no similar process is mandated for dark pools,[134] though such disclosures would seem advisable considering the increasing complexity of the electronic trading systems they employ.[135] And though most users of dark liquidity are sophisticated institutional traders, dark pools often rely on smaller retail investors to supply needed securities on the sell side.[136] Increased disclosure might be especially important in the case of dark pools owned by large investment banks, where concerns continue regarding what protections are in place to ensure that orders are processed fairly and ethically.[137] Arguably, by focusing on organizational disclosure instead of looking to prohibit particular transactions, the SEC could better monitor developments in the use of dark liquidity while keeping more investing decisions in the hands of investors. Such a proposal, although challenging to devise, would be more in keeping with the Exchange Act's original intention of regulation by disclosure, as opposed to piecemeal monitoring of specific types of transactions.

Conclusion

At it stands, the SEC's proposal concerning undisplayed liquidity is certainly laudable, but perhaps incomplete. Dark liquidity remains an attractive option to many investors, and the Commission would do well to remember that the considerations that motivate its use will continue to exist. Overall, the proposal's plan for an increase in post-trade transparency for ATS trades is warranted and would certainly help ensure that U.S. securities markets are fair despite the use of dark liquidity. The SEC's attempt to lower the percentage of trading volume that can be kept off public exchanges also shows that the Commission is mindful of keeping the vast majority of securities transactions on light venues. It is not clear at this point, however, whether such concern is actually warranted. Unduly restricting the size and amount of dark liquidity transactions is most likely shortsighted, especially without any indication that dark pools, which provide an important service, have actually hurt investors.

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134 *See* Regulation ATS—Alternative Trading Systems, 17 C.F.R. §§ 242.300–.303 (2009).

135 *See* Von Kaenel & Malatestinic, *supra* note 47, at 16 (discussing how complex trading practices may have undiscovered risks).

136 *See* Interview by Steve Forbes with Seth Merrin, *supra* note 22.

137 *See supra* notes 65–67 and accompanying text.

In the end, the SEC's reaction to dark pools provides an interesting case study in one of the first areas of actual regulatory change in the aftermath of the economic downturn of 2008. Although the SEC's dark pools proposal does not require more disclosure by dark pools before they begin operations, it may be the case that such requirements will be added to Regulation ATS in the future. Overall, the proposed changes carry the promise of positive results and, hopefully, signify the first of many changes that will cast beneficial light on certain problematic loopholes in our current financial system.