SEC Proposes Rules To Make Dark Pools Disclose More Data

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The Securities and Exchange Commission proposed shining a bright light Wednesday on how so-called dark pools execute trades.

Supporters argue the new rules would provide long-needed transparency and oversight for the private trading systems, used mainly by institutional investors. Others worry they could chill a fast-growing business. But a key exemption for large orders might calm those hopes and fears.

The changes could benefit retail investors by requiring dark pools to disclose price quotes to public markets, something they rarely do currently. Dark pools generally execute large block orders.

By shedding more light on the activities of dark pools — run by Goldman Sachs (GS), Credit Suisse (CS), Barclays (BCS), Bank of America (BAC) and others — regulators aim to rein in a growing practice among big traders. In the first half of 2009, dark pools accounted for about 12% of overall daily trading volume in the U.S. vs. 8% in early 2008, aays research firm Aite Group.

Beware The Dark?

But the SEC's proposed changes focus on average trading volume involving specific stocks rather than overall U.S. flows. Under current rules, dark pools must publicly report quotes if they handle 5% of a stock's average daily volume.

The SEC has proposed lowering that threshold to 0.25%, which it says would be much harder for dark pools to circumvent.

"Dark pools by definition do not publish quotes," said Sang Lee, managing partner at Aite Group. "If they're required to provide that kind of transparency, you're essentially killing that business model."

Critics have charged that dark pools may reduce the information public markets use to set stock pricing and undermine volume reporting as well.

"The SEC is hoping that by lowering the threshold so dramatically, dark pools will be forced to display their quotes," said Cheyenne Morgan, analyst at research firm TABB Group.
"The upside for public investors is price discovery information once the 0.25% threshold is exceeded. What dark pools have been doing is that as a (stock) nears the 5% threshold they shut the security off and they won't trade it anymore."

To protect large investors, the SEC proposed exempting orders over $200,000 in value from the new rule. That would apply, for example, to a block order of 10,000 shares for a stock priced at $20.

But generally, cracking down on murky dark pools is a good move, says Joseph Saluzzi, a partner at Themis Trading, which trades stocks for institutional investors.

"With decimalization, the velocity of trading has skyrocketed. While this spawned some innovative products, nevertheless it has fragmented the marketplace and hurt the price discovery process in an unintended way," Saluzzi said.

"Never did (regulators) expect there would be over 30 dark pools trading, with a great number of them being internalization engines," he added. "And never did they intend for such a large percentage of the order flow to be regulated in a different way than orders on public exchanges."

Harvey Pitt, former SEC chairman and head of consultancy Kalorama Partners, says dark pools serve a need by executing large block orders efficiently. Institutions don't have to worry that savvy traders will spot their moves and disrupt pricing for stocks as big orders are being filled. Dark pools match buyers and sellers anonymously.

"The reason dark pools are successful is because they provide functionality the existing market mechanisms do not — one-on-one negotiations between buyers and sellers of size, with anonymity from public scrutiny, or the ability of market makers to (disrupt) the completion of the transaction," Pitt said in an e-mail.

"Nonetheless, there are always issues, even with innovative ideas. I think the SEC is sensibly trying to understand a growing phenomenon."

TABB'S Morgan says the SEC will likely review the $200,000 exemption, because "it leaves the door open for manipulation" by dark pools. She says the SEC may switch to a share-based exemption.

The largest dark pools are Credit Suisse's CrossFinder, Knight Trading's (NITE) Link, Goldman's Sigma X, Getco and LeveL, according to TABB.

"A lot of these big guys are going to be very vocal in fighting the proposed changes," said Morgan.
Liquidnet, which handles about 5.5% of dark pool volume, is one of the few private networks that provide limited access to outsiders. Last year, it shelved plans for an IPO due to market conditions.

The SEC is moving on several fronts.

In August, the SEC said it is mulling tougher rules on "flash trading," a computer-based stock-trading technique that some analysts say puts retail investors at a disadvantage. With flash trading, the SEC says high-frequency traders are able to look at other investors' orders before they are sent to the wider marketplace.

"Flash orders are more about the displayed market," not dark pools, says Lee.

The SEC needs to take a broader view, says Bernard Donefer, a professor at Baruch College in New York.

"Rather than focus on flash (orders) and dark pools I wish they would step back and start with bigger picture, market structure issues," he said. "The SEC should look at dark pools, ECNs, and a host of liquidity issues tied to a highly fragmented market."

The SEC could adopt the changes after 90 days for public comment.