

SEC PROPOSES RULES TO INCREASE DISCLOSURE BY “DARK POOLS”

On November 13, 2009, the Securities and Exchange Commission published proposals to increase regulation of alternative trading systems (“ATs”) that do not publicly display quotations in the consolidated quotation data, so-called “dark pools.”¹ Comments are due on February 22, 2010.²

Summary

The Commission’s proposal has three components:

- amending the definition of “bid” or “offer” in the Regulation NMS quoting requirements to apply to “actionable” indications of interest (“IOIs”) (generally described as IOIs that are functionally equivalent to quotes), unless the actionable IOI is for a block-size trade having a market value of at least \$200,000;
- lowering the Regulation ATS average daily trading volume threshold that triggers quote display and execution access requirements for ATs from five percent (5%) to one quarter of one percent (0.25%); and
- amending the joint-industry plans for publicly disseminating consolidated trade data to require real-time disclosure of the identity of dark pools and other ATs on the reports of their executed trades.³

The new 0.25% threshold, if adopted, would apply only to the order display and execution access requirements under Regulation ATS (Rule 301(b)(3)). The Commission does not at this time propose to amend the 5% trading volume threshold applicable to the “fair access” and non-discrimination requirements under Regulation ATS (Rule 301(b)(5)).

Adoption of the proposed changes would require (1) trading venues that currently display actionable IOIs only to certain parties to modify their practices, and (2) more ATs to display their best quotes (including actionable IOIs) publicly.

¹ SEC Release No. 34-60997 (the “Release”); <http://www.sec.gov/rules/proposed/2009/34-60997.pdf>.

² Securities and Exchange Commission, 74 Fed. Reg., 61208, 61208 (Nov. 23, 2009).

³ These three rule change proposals, which follow the Commission’s recent proposal to eliminate the exception for marketable “flash orders” from the Quote Rule in Regulation NMS, are part of the Commission’s broader review of equity market structure and trading technology and practices. See our Client Memo dated September 23, 2009; http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3111/SEC_Proposes_To_Ban_Flash_Trading.pdf. The Commission stated in the Release that it is considering publishing in the near future a concept release on a wide range of market structure topics, including the “benefits and drawbacks of dark liquidity in all its forms, including dark pools, the order flow arrangements of OTC market makers, and undisplayed orders on exchanges,” suggesting that the Commission’s review of these and related issues is far from complete. *Id.* at 61209.

Actionable IOIs

The Commission is proposing to amend the definition of “bid” and “offer” in Rule 600(b)(8) of Regulation NMS. The terms “bid” and “offer” determine the public quoting requirements under Regulation NMS and Regulation ATS, including restrictions on the display of locking and crossing quotations. Currently, IOIs, a term that is not defined in Regulation NMS, are excluded from the definition of “bid” and “offer.” Under the Commission’s proposal, the definition would be amended to exclude only (a) IOIs that are not actionable and (b) actionable IOIs involving “a quantity of NMS stock with a market value of at least \$200,000 that are communicated to those who are reasonably believed to represent current contra-side trading interest of at least \$200,000” (“size-discovery IOIs”).⁴

While not defining specifically the term “actionable IOI,” the Commission stated in the Release that an IOI would be considered “actionable” if it explicitly or implicitly has all of the following information and, therefore, would function essentially as a quote: (a) symbol; (b) side (buy or sell); (c) price (even if no price is specified, if the recipient could reasonably assume that the order would be executed at the national best bid or offer (“NBBO”) or better, the price element would be satisfied); and (d) size (this element could be satisfied if the quoting venue has a minimum trading size). The Commission would consider all of the pertinent facts and circumstances to determine whether an IOI is “actionable,” such as whether a trading center has established by course of conduct an expectation among the recipients of the IOI that responding with orders will result in an execution.

Customers of dark pools, as well as quoting venues, will continue to have the ability to instruct that their orders not be displayed pursuant to Rule 604 of Regulation NMS. The Commission is taking the position, however, that customers cannot agree to have the information in an actionable IOI disseminated to a select group while withholding that information from the public because, in the Commission’s view, doing so would not only raise fairness concerns but could discourage the public display of trading interest and reduce quote competition among markets.

The Commission seeks comment on, among other things, the pros and cons of having an express definition for “actionable IOIs” in Regulation NMS, the benefits of actionable IOIs that could not be realized if they are defined as bids or offers, and the appropriateness of the size-discovery IOI exception.

We note that the Commission’s reluctance specifically to define an “actionable IOI” could create significant compliance difficulties. At the Commission meeting in which issuance of the proposal was approved, however, the SEC’s Division of Trading and Markets stated that the absence of clarity is designed to prevent evasion of the requirement.

⁴ In contrast to the definition of “block size” in Regulation NMS, which includes a volume threshold (at least 10,000 shares) as well a market value test, the Commission proposes defining the size-discovery exclusion in terms of market value only. The Commission states that including a volume threshold would mean that relatively low-value orders could qualify for the exclusion in the case of low-priced stocks, whereas the size-discovery exclusion should be limited to “truly large-size” orders.

ATS Display Obligations

Second, the Commission is proposing to amend Rule 301(b)(3) of Regulation ATS to reduce the average daily trading volume threshold that triggers quote display and execution access requirements for ATSs. Currently, an ATS is not required to publicly display its best-priced orders for an NMS stock, even if such orders are widely disseminated, if the ATS's average daily trading volume in that stock during four of the preceding six months is less than 5%. The proposal would lower that threshold to 0.25%. In the proposal, the Commission notes that few, if any, dark pool ATSs exceed the 5% threshold for any NMS stocks, even though as a group, they account for a significant share of trading volume. This proposed amendment would essentially eliminate for most ATSs the ability to display orders for an NMS stock to more than one person⁵ (including in the form of actionable IOIs) without making the best-priced quotations for that stock available in the consolidated quotation data. ATSs that display orders pursuant to the display requirement would also have to provide broker-dealers the ability to execute against those orders.

The proposal contains a “size-discovery” exclusion similar to the size-discovery IOI exception described above. Orders having “a market value of at least \$200,000 that are displayed only to those who are reasonably believed to represent current contra-side trading interest of at least \$200,000” would not be subject to the order display and execution access requirements.

The Commission seeks comment on, among other things, the appropriateness of the new threshold, whether subscribers of ATSs would change how they use ATSs if the new threshold were adopted, and how the proposed amendments would impact the trading costs for institutional investors.

ATS Post-Trade Transparency

Third, the Commission is proposing to amend the joint-industry plans that provide for the dissemination of last sale information for equity securities. This proposal is intended to improve the post-trade transparency of dark pools and other ATSs by requiring the real-time disclosure of the identity of particular ATSs on the reports of their executed trades. Currently, ATSs must report their trades to FINRA for inclusion in the consolidated trade data, but unlike the trade reports of registered exchanges, which identify the exchange on which a trade was effected, the published trade reports of ATSs merely indicate the trades as “OTC trades” without identifying the ATS. The Commission proposes a limited exception for a block-size trade of at least \$200,000 to continue to be reported as an “OTC trade.”

This rule change, if adopted, would provide information that currently is not publicly available about ATSs' (including dark pools') aggregate trading volumes and trading volumes for specific stocks. On the other hand, the proposed changes may cause undue information leakage. The Commission seeks comment on, among other things, the timing and level of detail that ATSs should be required to provide about their trading activity.

⁵ The Commission proposes amending the rules to clarify that “person” means both subscribers and non-subscribers of the ATS, but does not include ATS employees.

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