<u>Response to SEC Questions Regarding</u>
<u>'Regulation of NMS Stock Alternative Trading Systems' File Number S7-23-15</u>

The SEC, along with most of the industry and academia agree that Alternative Trading Systems ("ATSs") must become more transparent and provide clear disclosure for the benefit of investors.[1] The same data produced by exchanges should also be provided by ATSs, including transactional short sale data. Increased transparency into the structure and operations of ATSs would allow regulators to be more efficient, advisors to make more informed decisions on behalf of clients and investors to measure the benefits and disadvantages of each trading venue.

We support the SEC's proposal to significantly increase ATS disclosure requirements in light of the current market structure that has drastically changed since Regulation ATS was adopted in 1998.

There are many potential conflicts of interest for dark pools that constitute the majority of ATS trading arising from their relationships with their affiliates (broker-dealers, clearing firms, other trading venues, etc.). In order to protect investors and the integrity of the U.S. markets, these conflicts of interest should be clearly disclosed.

<u>However, it is important not to become buried by the technicalities of disclosure, but holistically consider the risks that could be ultimately posed to the financial system structure. The below issues raise questions regarding the value and relevance of ATSs to investors and the markets and whether they should still continue operations.</u>

ATSs are a significant portion of volume in the marketplace. At times, up to 20% of trade volume is executed through ATSs in important U.S. securities. This trading is concerning because of its potential growth in volume.

ATSs are competitors to exchanges, but do not have the same oversight, transparency requirements or responsibilities. It is clearly unfair competition for ATSs to be subject to far less requirements than exchanges while executing a large percentage of the market volume.

It should be considered whether ATSs are healthy for the long-term prospects of a robust, open trading system that has successfully existed in the U.S.

ATS Misrepresentations to Investors and Regulators

As alleged by the New York Attorney General, some ATSs have allowed high frequency traders to aggressively take advantage of buyers (pension and mutual funds and likely regular investor order flow) in dark markets with ***<u>toxic</u>*** predatory trading. We suggest regulators take further steps to determine just how toxic this trading really is.

[1] As the SEC cited in its proposed rules on the *Regulation of NMS Stock Alternative Trading Systems*, there are a large amount of supportive comment letters from the industry for increased disclosure and transparency requirements for ATSs in response to related SEC proposals over the last several years.

According to New York Attorney General Eric Schneiderman's allegations against Barclays filed June 25, 2014:[2]

- "As one part of its *marketing effort*, Barclays created and disseminated analyses about the landscape of trading in its dark pool, purporting to show **how clients were protected from aggressive high frequency trading** activity and underscoring Barclays' **commitment to transparency**. One such analysis was contained in a widely-disseminated document intended for **institutional clients** titled Liquidity Profiling – *Protecting You in the Dark*."

- "On October 5, 2012, a draft version of the analysis was circulated by email to ***senior executives*** in Barclays' Equities Electronic Trading division. The accompanying email noted that Barclays "de-emphasized the number of ELPs [electronic liquidity providers, or high frequency traders] by moving them to the back." The email also stated that the chart "***remov[es] Tradebot***." Tradebot Systems had historically been, and was at that time, the ***largest participant in Barclays' dark pool***, with an **established history** of trading activity that was ***known to Barclays as "toxic."*** Those alterations had the effect of obscuring the amount of high frequency trading activity in the dark pool by *disguising the total number of high frequency trading firms, and **deleting one significant firm altogether***.

  In a response email, one employee objected to the modified chart, stating that removing Tradebot from the analysis was a **falsification of the data**.

  In response to this objection, a Director in the Equities division wrote that "the point of the chart is not to show what's in the pool. **The point is to market our capability . . . to monitor individual participants** in the pool.""

- "In 2013, senior Directors in the Equities Electronic Trading division began a broad analysis of Barclays' order routing practices, gathering detailed trade data from over 100 million unique trades. Upon analyzing the data, these Directors determined that Barclays had an **extremely high "internalization rate**" – that is, a high rate of **routing client orders into Barclays' own dark pool**. The analysis also determined that certain trading venues were disadvantaged by Barclays' routing procedures, either because Barclays was submitting orders that had no chance of being accepted in that particular venue, or because those venues were not seen as financially beneficial for Barclays."

  "The analysis also determined that the trading venues to which Barclays routed unfilled orders (after first having routed them to its own dark pool) tended to be **venues hosted by high-speed trading firms**, "**[n]one of which**," recalled one Director, "**had a reputation for being favorable to clients** from an execution perspective." Those venues included Knight Capital, Getco, and Citadel."

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[2] The People of the State of New York by Eric T. Schneiderman, Attorney General of the State of New York v. Barclays Capital Inc. and Barclays PLC, June 25, 2014

On January 31, 2016, Barclays admitted wrongdoing and agreed to settlements with the New York Attorney General and the SEC. Robert Cohen, Co-Chief of the SEC's Market Abuse Unit stated:[3]

> "Barclays misrepresented its efforts to police its dark pool, overrode its surveillance tool, and misled its subscribers about data feeds at the very time that data feeds were an intense topic of interest. Investors deserve fair and equitable markets without this misbehavior."

In the same January 31st release, the SEC announced Credit Suisse also settled actions with the New York Attorney General and the SEC regarding violations within two of its ATSs. Joseph Sansone, Co-Chief of the SEC's Market Abuse Unit stated:

> "Two Credit Suisse ATSs failed to operate as advertised, and failed to comply with numerous regulatory requirements over a multi-year period. The Commission's action today sends a strong message that the agency will continue to scrutinize ATSs for compliance with the securities laws."

The above alleged Barclays and Credit Suisse falsely advertised the benefits of dark pools for pension and mutual funds trading large blocks of shares. The result of such behavior is in direct opposition to the reasons for the very existence of ATSs.

What Were/Are ATS/Dark Pools Designed to Be

As the SEC stated in this proposal:

> "Dark pools ***<u>originally</u>*** were designed to offer certain market participants, particularly **<u>institutional investors</u>**, the ability to minimize transaction costs when executing trades in **<u>large size</u>** by completing their trades without prematurely revealing the full extent of their trading interest to the broader market"..... "The traditional definition of block orders are orders for more than 10,000 shares, however average trade sizes can far exceed this and be as high as **500,000 shares per trade**"..... "Most dark pools today, however, primarily execute trades with small sizes that are more comparable to the average size of trades on registered national securities exchanges, which is **<u>181 shares</u>**."

The above raises several concerning issues:

1. It is widely recognized that dark pools were intended to be venues to match trades between large buyers and sellers at best prices. Obviously, the purpose of the majority of dark pools has morphed into something completely different than 'originally designed'. Small average trade sizes are evidence that these venues are no longer for the ***<u>beneficial</u>*** purpose of aligning block size trades between large traders.

Most dark pools are trading in these small sizes, indicating a consistent pattern of trading is occurring throughout the majority of liquid dark pools. Table 1 shows the average trade size

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[3] *Barclays, Credit Suisse Charged With Dark Pool Violations, Firms Collectively Paying More Than $150 Million to Settle Cases*, January 31, 2016 https://www.sec.gov/news/pressrelease/2016-16.html
SEC Administrative Proceeding File No. 3-17077, In the Matter of Barclays Capital Inc., January 31, 2016 https://www.sec.gov/litigation/admin/2016/33-10010.pdf

by top volume ATSs during three different time periods: the weeks beginning May 12, 2014 and January 11, 2016 and March 30 through June 26, 2015 (as included in this SEC proposal). For the week of May 12, 2014, these 17 ATSs accounted for 87% of the total volume and 93% of the number of trades executed in Tier 1 securities on all ATSs. Similarly, in the January 2016 period the same ATSs accounted for 89% of the total volume and 94% of the number of trades executed in Tier 1 securities on all ATSs. <u>None of these top volume ATSs appear to be executing ***block trades***</u> during any of the three periods.

Table 1 – Average Trade Sizes in Top Volume ATSs for Three Time Periods: the Week of May 12, 2014, March 30 through June 26, 2015 and the Week of January 11, 2016[4]

MPID/ Name	**Average Trade Size (in Shares) May 12 - May 16, 2014**	**Average Trade Size (in Shares) March 30 - June 26, 2015 (from SEC Proposal)**	**Average Trade Size (in Shares) January 11 - January 15, 2016**
CROS Credit Suisse Securities (USA) LLC	172	181	199
LATS Barclays Capital Inc.	181	172	184
UBSA UBS Securities LLC	122	157	167
MLIX Merrill Lynch, Pierce, Fenner & Smith Inc	196	224	213
MSPL Morgan Stanley & Co. LLC	265	235	288
DBAX Deutsche Bank Securities Inc.	169	185	207
SGMA Goldman Sachs Execution & Clearing, L.P.	167	172	204
FLOW Lavaflow, Inc. (Citigroup)	179	N/A	N/A
KCGM KCG Americas LLC	138	171	172
JPMX J.P. Morgan Securities LLC	268	231	267
ITGP ITG Inc.	257	284	273
IEXG IEX Services LLC	334	245	222
BIDS Bids Trading L.P.	437	511	592
KCGB KCG Americas LLC	114	N/A	N/A
ICBX Instinet Continuous Block Crossing System	240	257	244
EBXL Level ATS	159	162	174
CXCX Citigroup Global Markets Inc..	193	223	253

One of the historical reasons for the existence of ATSs was described by the SEC in 1998, when the Commission found that market makers were taking advantage of their knowledge when an institutional order was being executed.[5] Some market makers would shift bids/asks and spreads in their favor and investors such as pension and mutual funds were provided with less favorable prices than they should have obtained.

Today, many dark pools are operated by the market makers, as shown in Table 2. Most of these market makers were significant market makers in 1998. In 1996, many were involved in a

[4] Lavaflow (FLOW) and KCG Americas (KCGB) were no longer operating during the 2nd and 3rd periods shown in the table.
[5] SEC Proposed Rules, Regulation of Exchanges and Alternative Trading Systems, File No. S7-12-98, April 17, 1998 https://www.sec.gov/rules/proposed/34-39884.pdf

global settlement by 24 firms with the U.S. Department of Justice for collusion between the market makers to fix prices on the NASDAQ market.[6]

Table 2 – ATSs Owned/Operated by Market Makers as of February 1, 2016

Owner/Operator	**ATS**
BIDS Trading (Investors are: Bank of America Merrill Lynch, Barclays, Bloomberg, Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, J.P. Morgan, KCG, Lehman Brothers, Morgan Stanley, NYSE and UBS)	BIDS Trading, L.P.
LeveL ATS (Investors are: Citigroup, Credit Suisse, Barclays, and Bank of America)	eBX LLC
Morgan Stanley & Co. Incorporated	ATS-1
Morgan Stanley & Co. Incorporated	ATS-4
Morgan Stanley & Co. Incorporated	ATS-6
Barclays	LX
Barclays	Barclays DirectEx
Citigroup Global Markets Inc.	CITICROSS
Citigroup Global Markets, Inc.	LIQUIFI
Credit Suisse Securities (USA) LLC	CrossFinder
Credit Suisse Securities (USA) LLC	Light Pool
Knight Capital Americas LLC	KCG BondPoint
Knight Capital Group	MatchIt
Merrill Lynch	ATS-1
Goldman Sachs Execution & Clearing, LP	SIGMA X
UBS Securities LLC	UBS ATS
Deutsche Bank Securities, Inc.	SuperX
J.P. Morgan Securities LLC	J.P. Morgan ATS
ConvergEx Execution Solutions LLC	Millennium
ConvergEx Execution Solutions	NXP
State Street Global Markets LLC	BlockCross ATS
Interactive Brokers LLC	IBKR ATS
National Financial Services, LLC	CrossStream

The small trade sizes indicate something similar in the trading by Barclays and Credit Suisse may be happening within other dark pools. Should a different outcome be expected currently vs. in 1998, or are some dark pools *now* designed to still take advantage of the pricing to institutional investors? The above Barclays and Credit Suisse regulatory actions suggest the latter is true.

If institutional funds are being systematically stolen from through the dark pools, this is not healthy for the stakeholders of these funds, nor is it legal. A dark market price manipulation is fraud and against the laws, rules and regulations governing the U.S. markets just as the same is true for lit markets.

[6] *Justice Department Charges 24 Major NASDAQ Securities Firms with Fixing Transaction Costs for Investors,* July 17, 1996 http://www.justice.gov/archive/atr/public/press_releases/1996/228403.htm

The dark pool operators are not regulators/SROs and may be ill-prepared or unwilling to comply or cause compliance with securities regulations within their pools. Serious conflicts of interest have developed with some of the for-profit ATS/dark pool operators.

The larger question is; should dark pools even exist today given that they are not serving the purpose for which they were designed to fulfill?

2. Senior executives at Barclays knew that the counterparty to the majority of the trades was a “toxic” market participant. It is striking that this quote went to senior executives of Barclays. This appears to be a willful disregard not only for Barclays’ clients’ interests, but for whether the actual operations of the Barclays’ dark pool is in compliance with U.S. regulations.

As alleged by New York Attorney General Eric Schneiderman, in the case of Barclays, “Tradebot Systems had historically been, and was at that time, the ***largest participant in Barclays’ dark pool***, with an **established history** of trading activity that was ***known to Barclays as “toxic."***”

What could the definition of a toxic market participant be? Is it; a) one who front-runs transactions, b) is willing to circumvent regulation, c) is willing to sell securities short without borrowing (referred to as naked short sales by the SEC), d) constantly enters orders it intends to cancel for the purpose of spoofing the market, e) layers trades on top of each other not intending to execute them, but as a means to control the marketplace pricing, and f) is willing to virtually provide services on demand for its clients regardless of whether they are operating legally or not?

These are the types of trading actions that are generally thought of to be toxic and referred to by regulators at times as toxic. This is a definition that is not taken lightly in the securities field and here, senior executives at Barclays were informed by Barclays personnel that the contra party to most trades in Barclays’ dark pool was a 'toxic' trader.

3. The small trade sizes suggest that even large trades are being broken up into much smaller sequences. Why? Why break up trades into such small sizes if the counter party is generally one trader? How would this contribute to transactional cost savings for the pension and mutual funds?

Not specific to Barclays, but this is a process that has been/is generally used to conceal the nature of the trading that is occurring. At times, breaking blocks into smaller blocks is a method used to provide an illusion that a trade is being executed through many counterparties across multiple trading venues in order to conceal that just one party is contra to the trade. In some past cases, breaking trades into smaller sizes between the same counter parties has been used for other questionable purposes, including even laundering money.

What is unusual here is that ATSs and dark pools are in essence, a private market. Why Barclays itself did not simply use block trades to transfer the order to Tradebot is unclear. In other words, Tradebot was the counter party for the small trades, but it appears Barclays placed the institutions block orders in small trades. Since other ATSs are executing in such small trade sizes, is this a dark pool operator tactic to conceal non-institutional trades flowing through dark pools?

4. The small size trades suggest that in general, the more liquid dark pools may be routing even their regular customer orders through their dark pools. Moreover, as the SEC staff stated in 2013:

> "The aggregate trade size distribution on dark ATSs is similar to that observed for lit exchanges and does not seem to support the ***characterization*** of dark ATSs as venues that specialize in block transactions."[7]

In the development of ATSs, it was never a proposition provided by the industry that they were someday simply going to be routing venues for broker-dealer/clearing firms to internalize a significant amount of their regular client order flow. Disclosing this to the SEC would have changed the early discussions of ATSs and alerted exchanges to their loss of future trading volumes/revenues through these venues. If this was a part of the original proposal for ATSs, we doubt Regulation ATS would have been implemented as crafted.

The broker-dealers that may eliminate the need for public exchanges are clearly the benefactors from this structure, not the investing public. Is this healthy for the U.S. market system? ***At what point do ATSs/dark pools become such a percent of the market that some exchanges are no longer viable?***

5. Large trading firms operate their own dark pools. These large volume firms could use their own dark pools and bypass exchanges for their client trading, reducing volume executed through exchanges and **harm public price discovery**. As the SEC stated in this proposal:

> "While low levels of trading on NMS Stock ATSs are not harmful, price discovery is harmed for high levels of trading on NMS Stock ATSs (i.e., when trading on NMS Stock ATSs in a given NMS stock exceeds approximately 10% of dollar volume)."

This is a clear red flag of harm that could develop from ATSs. Accurate price discovery is fundamental to the functioning of the capital markets. If dark pools can harm price discovery, they should be highly considered to be a threat to the well being of the financial markets.

6. Where did the shares come from that were purchased through Barclays' dark pool?

Tradebot was the 'largest participant in Barclays' dark pool' and it is an industry promotion that high frequency traders such as Tradebot generally have very little securities inventory as they are mostly flat in positions at the end of each day. This raises questions as to what was being sold to Barclays' clients whose orders were routed into its' dark pool for execution with Tradebot. For example, when an institutional client purchased hundreds of thousands of shares from Tradebot in Barclays' dark pool, what was Tradebot selling? ***Was Barclays or one of its affiliates the counterparty to Tradebot?***

If dark pool operators route client trades to a cooperating third party and then become the other side to those trades, then dark pools would be acting for their benefit as opposed to protecting their institutional client and providing a fair and efficient market. Moreover, this hypothetical scenario would constitute illegal pre-arranged trading in violation of a number of

[7] DERA Staff White Paper, *Alternative Trading Systems: Description of ATS Trading in National Market System Stocks*, Laura Tuttle, October 2013 https://www.sec.gov/marketstructure/research/ats_data_paper_october_2013.pdf

securities laws. This would clearly be against the public interest, the protection of investors, the maintenance of fair and orderly markets and is contrary to the spirit of Regulation ATS and the anti-fraud provisions of federal law.

This type of activity may become (if it has not already for some firms) another type of financial scheme that puts the ATS operator in control of client orders and cash. In this scenario, client orders are placed in essence on a private venue, ran through a cooperating counterparty and the end result of the transaction is simply a trade with the same firm who took the order in the first place. Money is transferred from the client to the benefit of the dark pool operator. Because the trades are within the same clearing firm, they could very easily be short sales not backed by borrowed assets (referred by the SEC as 'naked'), sold for full price and internalized to the ATS operator's books (not sent to NSCC/DTCC for clearance and settlement). This could result in a large quantity of undisclosed securities positions that are not settled and amount to massive leverage and re-leveraging within the system.

Purpose of ATSs

ATSs have advertised and were largely established for institutional traders to execute block trades. As SEC Commissioner Luis Aguilar stated when this proposal was published:[8]

> "Perhaps the greatest catalyst for the **rise of ATSs in recent years has been institutional investors' growing need to trade large blocks of stock** without causing markets to move against them. This need is not new, but it has become increasingly acute with the advent of algorithmic trading strategies and the diminished order sizes that have resulted. ATSs responded to this need by offering ever more trading on an anonymous basis, and without displaying specific order information before trades occur. These types of ATSs have come to be known as "dark pools."
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> **Dark pools initially <u>portrayed themselves as havens from predatory traders</u>**. They achieved this, in part, by excluding high frequency traders, who supposedly use brute speed to front-run institutional investors' large orders. **<u>Lured by this promise of safety, institutional traders embraced ATSs</u>** as a solution to their trading needs. Unfortunately, **all too often the <u>*safety these investors sought proved illusory*</u>**."

Today, it appears many ATSs are not operating according to their advertised goals of assisting buyers/sellers of block trades to find liquidity in a relatively protected environment.

Who Benefits from Today's Dark Pools

According to the actions against Barclays and Credit Suisse, the ATSs were not benefiting institutional traders, which is in conflict with how they were originally designed and advertised.

Instead, in the case of Barclays, institutional orders were not protected from and actually were routed to aggressive and toxic high frequency traders known to not provide best market executions. Importantly, Barclays' senior executives knew this.

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[8] SEC Commissioner Luis A. Aguilar, *Shedding Light on Dark Pools*, November 18, 2015 https://www.sec.gov/news/statement/shedding-light-on-dark-pools.html#_edn28

The trade sizes across the board in dark pools suggest there may be something similar happening in many of the other market maker owned venues. The benefits of these ATSs appear to be to the firms running the dark pools. If it was not to their benefit, they probably would not be operating the ATS in the first place. In other words, they are likely taking advantage of their institutional business and possibly their non-institutional clients.

It appears the purpose and the intended benefactor of the majority of today's ATS trading has completely changed from the original design. A flip has occurred from institutional benefits to broker-dealer/dark pool benefits.

What Risks do Dark Pools Present

When dark pools are not operated in the clients' best interest and not according to U.S. securities laws, rules and regulations, there are many risks and disadvantages. Institutional traders are disadvantaged by an increasing cost of trading, which in turn increases the cost for their stakeholders, whom are largely average American citizens.

There is a risk ATS operators may be internalizing the transactional activity and selling institutions securities at full price that, in essence, may not exist. While this is a potentially tremendous profit scenario for the ATS operator, it may leave generally long-term investors, such as mutual and pension funds, without adequate assets behind their securities positions. Under securities law and contract law, the institutions should be receiving protection and assurance they are purchasing real shares.

In other words, the institutions may have purchased something for full price they likely would not purchase at all if they knew this was occurring. The end result could be very large undisclosed liabilities at these firms. In essence, the owner of the dark pool (market maker/clearing firms) may be trading against the long investing institutions, a.k.a. its clients.

Over time, growing trading through these types of ATSs could seriously harm U.S. exchanges making it difficult for some to survive.

At the very least, the illusion of the dark pool safe trading venues for large institutional trades results in an actual deficiency of a safe haven for institutions in which to trade.

Possible Solutions

Perhaps, one type of solution would be to establish a neutral utility type exchange for large block trades with access provided only to those participants that own or wish to purchase large blocks of securities that are issued by public companies or ETPs.[9]

As a concept to ensure proper operation of this system; a) transactions between large buyers and sellers could be negotiated, b) the instructions of the trades would then be sent to the clearing firms of the funds/participants, c) the clearing firms confirm the intent of the trade, i.e. price and volume between buyers and sellers, d) the funds/participants reconfirm to the clearing firm their agreement to the transaction, e) the clearing firms then instruct the DTCC to appropriately disperse funds and transfer shares accordingly, f) the DTCC would then send a

[9] The institutional buy side is attempting to structure a different trading venue to reduce their risks of abuse from the types of trading discussed above. An example is a recently launched ATS in November 2015 called Luminex.

confirmation to the clearing firm(s) that the institutional transaction has been completed, forwarded to the transaction participants, and g) the trade would then be reported to the consolidated tape with the market identifier indicating this particular utility exchange.

The types of orders in this system could be designed to, as much as possible, conceal the full interest of a fund. For example, rather than expressing an order to sell an entire 100,000 share position, an order might only show a block of 10,000 shares then when another institution expresses interest to buy, they could negotiate between each other for the 10,000 or more shares, if they so desire.

This type of system would not necessarily eliminate the knowledge of interest in these orders between firms. However, it would not give an advantage to a single clearing firm operating a dark pool of knowledge of interest that would allow them to front-run the trades. DTCC confirmations for transfers of ownership between institutional buys and sellers (regardless if they have the same or different clearing firms) would alleviate the possibility that institutional funds would be left without actual ownership of securities.

If there is not sufficient interest from other institutions in the exchange for a particular security, the fund would still have the ability to go to the open market and execute trades as they do today.

Banks and other large sellers of blocks that wish to enter this market would be welcome, with the caveat that there is no short selling. If shares are listed in a sale order, they must be in possession of the seller and actually for sale. Following a successful negotiation and sale, the shares would be transferred/accounted for within the DTCC.

With the high frequency trading and market making removed, the amount of trading on this type of an exchange should be relatively small, so the exchange does not have to be complex.

Conclusion

The real question/concerns here may not be that of disclosure, but really what is the value to the marketplace of having these dark trading venues, which have morphed into something completely different than 'originally designed' and are not benefiting the large traders as intended.

If there is no value or benefit to the marketplace, where is the compelling justification to keep dark pools operating? If dark pools might cause risk to the markets, the reasons to disallow them become much stronger.