Woodbine *Opinion*

Views on Issues Impacting the Capital Markets by the Analysts of Woodbine Associates

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Early Thoughts on the SEC Proposals to Strengthen Regulation on Dark Pools

On Wednesday, October 21st, the Securities and Exchange Commission (SEC) held an open meeting in Washington, DC to address what it perceives as a growing lack of market transparency with respect to non-displayed venues and the emergence of a "two-tiered" market structure in which in which the public is deprived of information and denied access to liquidity available to institutional traders. At that meeting, the SEC put forth a series of proposals it believes will enhance transparency, reduce asymmetries, and enhance public confidence in the equity markets. The following proposals for were put forth for consideration and comment:

- “Actionable” indications of Interest (IOIs) should be subjected to the same disclosure rules as displayed market quotes.
- The "Fair Access Rule" volume threshold (the threshold at which point an alternative trading system (ATS) must publicly display quotes in a security and make the quoted liquidity publicly accessible) should be reduced from its current level of 5% to 0.25% of average daily volume.
- Subject ATSs to the same post-trade information disclosure requirements as exchanges by amending existing rules to require real-time disclosure of the identity of a non-displayed venue that executed a trade.

Non-Displayed Venues and Volume Restrictions

Founded or unfounded, attention on the growing market share of non-displayed venues has raised concern over efficient security pricing in the open market. The premise is that the greater the proportion of a security’s volume executed in non-displayed venues, the less robust the price discovery in the open market and the greater the potential for derived prices to deviate from the fundamental value of the security. Circuitously, the potential for mis-pricing in non-displayed venues increases as prices in these venues is generally established by referencing the quote in the security’s primary (displayed) market.

The displayed/non-displayed liquidity discussion strikes at the center of market structure and execution quality issues. Non-displayed venues provide considerable value to traders through midpoint or near-midpoint execution, anonymity and little or no information leakage. The benefits of non-displayed execution can be substantial, especially for traders with large-sized orders or trading in securities with wide quoted spreads. Conversely, displayed venues are central to the important function of price discovery, the process by which buyers and seller derive a market price relative to the stock’s fundamental price and supply and demand factors. These venues openly display quotes and depth-of-book**.** Despite this transparency, displayed venues are no strangers to non-displayed liquidity. Most exchanges and ECNs offer special order types that rest on their order books and display none, or only a small portion, of the shares available for execution.

In our view, the most important of the three proposals is the decrease in the Fair Access Rule quote threshold. Established as part of Regulation ATS in 1999, the Fair Access Rule mandates that ATSs that display quotes to members and execute greater than a specified percentage of a security’s the average daily volume must make quotes publicly available and the associated liquidity publicly accessible. The threshold of 20% of average daily volume established with the implementation of Regulation ATS was amended to 5% under Regulation NMS in

2005. In the current proposal, the SEC intends to further reduce this threshold to 0.25% of average daily volume while exempting orders equal to or greater than $200,000.

The intention behind the SEC proposal to reduce the Fair Access Rule threshold appears to be to "reclaim" small-sized order flow for price discovery once the threshold has been met while preserving the benefits of non-displayed execution for larger orders. Though well-intentioned, the proposed change would largely redistribute small-sized orders among other non-displayed venues when the threshold at one had been met. Though ultimately, most orders are likely find their way into the displayed markets due to comparatively low probability of execution within a non-displayed venue, the migration may not occur as immediately or to the degree desired.

As proposed, the change in the volume threshold is also likely to increase the complexity of institutional trading. A lower threshold would place additional burden on traders by requiring them to be alert as to the shifting landscape of displayed and non-displayed venues in the securities in which they trade. Consider the difficulty for a trader responsible for positions in ten securities which could potentially be executed in forty venues. Also consider the degree to which algorithms and custom automated trading strategies would need to be retooled. The proposed change, if enacted, might simply amplify the extent to which "liquidity chases liquidity" across venues, resulting in increasing frustration in filling orders and intensified trader demand for non-displayed execution.

If price discovery is a primary concern, a better solution might be to prohibit *any* non-displayed execution in a security once the 5% threshold had been exceeded at *any* non-displayed market venue or by non-displayed means at any displayed market venue. An exception for block-sized orders (greater than 10,000 shares) would be incorporated in the solution to preserve the value of non-displayed execution for large, difficult-to-trade orders. Other exceptions might also be required (for example, an exception for "virtual blocks", a series of small-sized, generally midpoint executions across a range of non-displayed venues that, when completed, comprise a price improved block-sized execution, etc.).

A solution such as this would ensure that retail-sized orders (less than 10,000 shares), the most important to price discovery, would be diverted to the open market once 5% of a security's average daily volume had been executed in a non-displayed manner in a single location. This would ensure the continuation of efficient price discovery in the displayed market while preserving non-displayed execution for orders of the size for which it is most beneficial.

Actionable IOIs and Disclosure

The proposal to make actionable IOIs subject to the same rules of disclosure as regular quotes is food for thought. As was the case with Flash Orders, the SEC has expressed concern that non-displayed venues that incorporate and disseminate IOIs to their membership (a subset of the overall market) may, in fact, create a two-tiered market. To avoid this adverse market structure, The SEC has put forth that actionable IOIs should be subject to the same disclosure requirements as regular quotes. However, it is not precisely clear at this time what the SEC has in mind or how such a proposal might be implemented.

The SEC *appears* to define an "actionable" IOI as one that "explicitly or implicitly" informs the recipient about trading interest in a non-displayed venue that is better than the best prevailing quote in the displayed market.

The definition, published SEC commentary, is not clear and, by all indications, there was a lack of clarity when this topic was discussed at the SEC meeting.

If the definition of an actionable IOI is as we have interpreted, it opens up a range of questions. Will non-displayed venues that incorporate IOIs in their operation and have a trading interest for midpoint execution be required to display those IOIs alongside quotes and make that liquidity available to all market participants? How can/will/should this be done?

Mandating non-displayed venues to manage actionable IOIs as if they were publicly displayed quotes, making them available to the entire market and allowing qualified market participants access to that liquidity, in many ways, could subject the non-displayed venue and its membership to gaming and predatory trading strategies to which they are currently not exposed. This could have a range of consequences. However, at the moment, too much ambiguity exists around this proposal. Accordingly, we will defer further discussion on this point until the full text of the proposed amendment is released and more information is available.

Post Trade Reporting

The proposal to amend existing rules so that ATSs are brought into line with exchanges in terms of real-time, post-trade disclosure is really of little consequence to parties executing in a non-displayed venue. Despite some immediate commentary that non-displayed venues would be "hurt" if they had to print on a real-time basis, identify themselves, and provide transaction details including price and quantity, post-execution market movement due to information leakage is highly unlikely.

Ex-poste price movement based on a print is improbable for reasons. First, there is often a delay between execution and reporting. Trading venues have 90 seconds to report a trade before it is considered late. Still, even if a trade report prints only a few seconds after execution, that is an eternity in the current high-speed, automated environment. Second, a print does not indicate whether an order has been filled or if there are residual shares. If residuals exist, the print provides no indication as to the side or size of the residual, or the degree of urgency the trader has to complete the order. In effect, a print is pretty much useless from an information standpoint on a real-time basis.

Experience supports this view. Prior to 2005 four principal venues comprised the non-displayed market. All were block-oriented. Some operated as call markets and some on a continuous basis. When a print of size went up, it was relatively easy to determine which venue was responsible. There were no sudden price movements or other irregularities. This was because, at the time of execution (not when the print went up), there was no information leakage. All that was known was that two parties met anonymously to transact a particular share quantity.

The reporting requirement is meaningful. Knowing where a particular execution occurred might suggest to a trader seeking liquidity that additional liquidity *might* exist at that venue if there are trade residuals, if the trader is on the right side of the market to execute against the residuals, and if the counterparty with the residuals is willing to trade. Reporting would also useful in that aggregate execution statistics could be compiled on detailed basis, where at the present time that is not possible.

Market evolution is, in many ways, compromise. No truly perfect structure exists and asymmetries are always present among participants. However, through careful, intelligent, deliberate action, improvements to market operation can be implemented while adverse, unintended consequences can be minimized. Such an approach is especially important when considering a topic of the magnitude of displayed and non-displayed liquidity.

For More Information Contact:

Matthew Samelson
Principal
Woodbine Associates

(203) 274-8970 x 201

msamelson@woodbineassociates.com

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