Commentary: Shedding Light on the Dark Liquidity Debate

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The first bugle sounded in the battle over dark pools challenged flash orders, which provided customers a first look at certain orders before they were made available through the public quotation stream to the great unwashed mass of public investors. The current debate involves a similar issue – whether the institutional customers of dark pools should be able to show their orders on a selective basis to certain other persons without also making them available to a larger audience. The battle results from a fundamental flaw in the design of the Securities Exchange Act of 1934, which is the source of a growing conflict in market regulation.

As discussed in prior articles, the Exchange Act creates certain institutions and then imposes obligations on those institutions. Most relevant here, the Exchange Act creates something called a national securities exchange. The business of a national securities exchange is to provide a marketplace for people to trade securities. The Exchange Act also required a national securities exchange to be a self-regulatory organization, which means that it must make rules for its members and adjudicate and enforce those rules.

A broker-dealer, another institution created by the Exchange Act, is required to be a member of a self-regulatory organization. In most cases, this means that a broker-dealer is a member of a national securities exchange. Broker-dealers that transact business off exchange in the over-the-counter markets are required to be a member of the Financial Industry Regulatory Authority (FINRA), which is also a self-regulatory organization. Only broker-dealers can engage in securities transactions on national securities exchanges.

The Exchange Act reflected the technology of its time. In 1934, stock exchanges consisted of physical trading floors. There is a natural limit on the number of human beings that can inhabit any physical location. So, limiting access to stock exchange floors to broker-dealers was, if nothing else, required to maintain crowd control.

But, it is also useful to realize that self-regulation imposes substantial costs on the business of running an exchange that stock exchanges would not voluntarily incur in the absence of regulation. The New York Stock Exchange did not maintain rule-making, adjudication and enforcement operations until legally required by the Exchange Act.

As technology has changed, the institutional framework that established by the Exchange Act has come under increasing strain. Electronic stock exchanges provide a virtual marketplace for people to transact business. There is no meaningful natural limit on the number of people that can transact business effectively in an electronic virtual marketplace.

This tension became evident in 1988, when RMJ Securities Inc applied to the SEC for permission to operate a system that would execute trades by matching electronically bids and offers from their clients. RMJ hoped to attract business from broker-dealers, but also from institutional investors that were not broker-dealers. RMJ's application therefore presented the SEC with a Hobson's choice. Was RMJ an exchange or a broker-dealer?

RMJ's system brought together buyers and sellers of securities to execute securities transactions, which is the fundamental business of an exchange. In fact, the only way that RMJ's business differed from that of an exchange is that the marketplace RMJ proposed to operate was virtual, rather than a physical location. However, if RMJ was classified as an exchange, only broker-dealers could transact business there. In addition, RJM would have been required to act as self-regulatory organization, which involves the substantial costs of making and enforcing rules for its members. RMJ proposed to have customers, established by contractual arrangements, rather than members.

But, there was a much more practical consideration. The SEC viewed RMJ as introducing a valuable innovation into the securities markets. The costs of a requirement to institute self-regulation would have doomed it from the outset. So, the SEC opted to classify RMJ as a broker-dealer and provided a number of exemptions from the regulations that generally apply to broker-dealers to make this classification workable.

The difficulty was that RMJ really didn't function as a broker-dealer. If anything, it was an exchange, a reality that the SEC eventually acknowledged ten years later when it created ATS regulation to clarify the status of RMJ's progeny. An ATS is classified by default as an exchange. It can obtain broker-dealer status by jumping through certain hoops and hurdles. The ATS Rules are an elegant bit of regulatory artwork. They are also conceptually troublesome and inherently unstable.

So, when flash orders were challenged, the immediate response was that broker-dealers do this sort of thing all the time. Broker-dealers do in fact provide a first look at orders to favored customers. Broker-dealers with access to valuable order flow are sought out by customers hoping to obtain an opportunity to "price the merchandise" before it is exposed to a wider audience. This is a practice that has been ubiquitous for as long as there have been broker-dealers. So, if an ATS is a broker-dealer, it ought to be able to show certain orders to some group of favored customers before exposing them to the public markets.

The same argument can and has been made in opposition to the proposed dark pool regulations. A broker-dealer that receives an order from an institutional customer does not immediately expose that order to the public markets. Instead, the broker calls other brokers in an attempt to arrange a trade that is more favorable to the customer than the terms available in the public markets. This is what broker-dealers are paid to do. So, if an ATS is a broker-dealer, it also should be able to send orders out to other ATS broker-dealers to obtain more favorable terms than would be provided in the public markets.

The difficulty is that categorizing an ATS as a broker-dealer is smashing a square peg into a round hole. In contrast to broker-dealers, exchanges do not discriminate among their customers – broker-dealers -- for order access. So, it was something of a novelty when, responding to competition from ATSs, several exchanges introduced flash orders. The fact is that ATSs are not broker-dealers, but rather a specialized type of exchange.

There are two ways to resolve this tension, only one of which is practical in my opinion.

In its recently published concept release, the SEC is examining whether broker-dealers should be permitted to withhold institutional trading interest from the public markets. Conceptually, this solution would alter the way broker-dealers have done business for eons. The SEC has been toying with this idea ever since 1976, which is produced the infamous Central Limit Order Book (CLOB) release. The appeal to this notion is that it would not require any changes in the Exchange Act.

On the other hand, the global experience in London, Toronto, and every other market that has erected them, is that institutions will not permit their orders to be submitted to CLOBs. So, the end result is that institutional orders trade nearly exclusively in upstairs over-the-counter markets, while retail orders end up in the CLOB – the evil two-tier market that the SEC is trying desperately to avoid.

I doubt that the SEC has the power, directly or indirectly, to require institutions to submit their orders into a CLOB or any other medium that will expose them to the public. As a society, we are not willing to require institutions to expose their orders to the public. And, I don't believe the G-20 would be willing to support us, either, which means that institutions would simply use non-U.S. brokerage facilities to hide their trading interests. So, I think this solution is impractical.

The other alternative is to change the Exchange Act, which would require an Act of Congress. National securities exchanges should not be self-regulatory organizations. Then there would be no need to distinguish ATSs and stock exchanges, and they would compete on a level playing field. The conduct of broker-dealers could then be consistently regulated by FINRA. The overwhelming

majority of broker-dealers are already FINRA members; so there would be no need to eliminate self-regulatory organization.

If exchanges were not self-regulatory organizations, institutions could trade using their facilities. In those cases where an institution believed that reserve orders and other similar exchange techniques were not adequate to prevent information leakage to the public, the institution could use a broker-dealer to represent it, either on an exchange or in the over-the-counter markets. That representation, it seems to me, could be accomplished by electronic broker-dealers, as well as by humans.

This alternative is practical, except for the temporary difficulty getting anything through Congress at this time, and overcomes the regulatory stress resulting from current technology.

I admit that this solution is not perfect. It accepts the reality that institutional orders will remain in the dark and will interact with other institutional orders without permitting public access to them, as they always have.

Dark liquidity, like poverty, will always be with us.

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