



Consultation Report: Issues Raised by Dark Liquidity. November 2010.

This report, prepared by the Standing Committee on Secondary Markets (TCSC2) and submitted to public consultation, analyses the characteristics of dark pools and dark orders and their current regulation in major jurisdictions. It also outlines the problems that may arise due to the development of this activity from a regulatory point of view and proposes six principles to address them. The deadline for submission of comments is 28 January 2011.

What are dark pools and dark orders? For the purposes of this report, a dark pool refers to any pool of liquidity (i.e. where securities can be sold) that can be accessed electronically and where the terms of a transaction are not made public before the transaction is executed (i.e. pre-trade transparency requirements need not be met). A dark order refers to an electronic order that can be executed on transparent markets, but which is exempt from fulfilling the pre-trade transparency requirements (i.e. it is a non-transparent order executed on a market where usually transparent orders are executed).

Why is dark trading (dark pools and dark orders) used? The main objectives of traders who use dark trading are: to preserve anonymity, to execute orders with minimal market impact (with consequent savings in costs), to try to avoid the effect of automated trading programmes (high-frequency trading), and to facilitate the execution of high-volume orders.

Why is IOSCO looking into this issue? The handling of dark trading has been made more efficient due to technological development, which has resulted in significant growth in this activity in recent years. In this context, it was considered advisable to analyse the possible adverse effects that this activity might have on the market and try to find the measures that regulators can take to avoid them.

Contents of the consultation report:

As a starting point in the work, a survey was conducted to examine possible regulatory problems that dark pools and dark orders could generate. This survey was sent to dark liquidity regulators, markets and users. The report now submitted for consultation seeks to tackle the most significant issues identified in this survey and ultimately to propose a set of principles to respond, from a regulatory point of view, to the problems that can be caused by this activity.

After the introduction (chapter 1), chapter 2 analyses the characteristics of dark pools and dark orders in major jurisdictions. Then, chapter 3 describes the regulatory frameworks in place in each jurisdiction. In both cases (types of trades and regulatory frameworks), the focus is on the differences between jurisdictions.

Chapter 4 defines the three major issues that may arise at regulatory level due to these activities:

- The impact on the price discovery process where there is a substantial number of dark orders or orders submitted to dark pools, which may not be published.
- The impact that these trades may have in terms of fragmentation on information and liquidity. The growing

number of dark pools may pose difficulties to investors when seeking liquidity.

- The impact on market integrity due to the difficulty of participants to have access to information and markets. Regarding those difficulties to access information, attention is drawn to the problems that can be created by IOIs , since that information about trading opportunities is only available to a few (only to those recipients that the sender has previously selected).

The last chapter of the report (chapter 5) sets out the draft principles intended to address, from the regulatory point of view, the concerns expressed in the previous chapter. TCSC2 believes that these principles should provide a basis for market regulation (including dark pools and dark orders). The proposal includes a total of six principles, whose implementation in the different jurisdictions should be done after considering the particular characteristics of each market.

Principles:

1. The price and volume of firm bids and offers should generally be transparent to the public (pre-trade transparency). However, where regulators consider permitting different market structures or order types that do not provide pre-trade transparency, they should consider the impact of doing so on price discovery, fragmentation, fairness and overall market quality.
2. Information regarding trades, including those executed in dark pools or as a result of dark orders, should be transparent to the public. With respect to this specific information, regulators should consider both the positive and negative impact of identifying a dark venue and/or the fact that the trade resulted from a dark order.
3. In those jurisdictions where dark trading is generally permitted, regulators should take steps to support the use of transparent orders. Transparent orders should have priority over dark orders at the same price within a trading venue.
4. Regulators should have a reporting regime and/or means of accessing information in venues that offer dark trading.
5. Dark pools and transparent markets that offer dark orders should provide market participants with sufficient information so that they are able to understand the manner in which their orders are handled and executed.
6. Regulators should periodically monitor the development of dark pools and dark orders in their jurisdictions to seek to ensure that such developments do not adversely affect the efficiency of the price formation process on displayed markets, and take appropriate action as needed.

The consultation report is available on: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD336.pdf>