

# Clients & Friends Memo

## Securities and Exchange Commission Proposes Regulation of Indications of Interest and Dark Pools

November 23, 2009

On November 13, 2009, the Securities and Exchange Commission (“SEC”) released a proposal (the “Proposal”) to amend the regulatory requirements “that apply to non-public trading interest in National Market System (“NMS”) stocks.”<sup>1</sup>

The Proposal consists of three separate changes to the current regulatory scheme, generally as follows:

- treating Indications of Interest (“IOIs”) that the SEC deems to be “actionable” as firm “bids” or “offers;”
- lowering the threshold at which alternative trading systems (“ATSs”) are obligated to publicly display their quotes in the NMS consolidated quotation data stream; and
- requiring real-time disclosure in the NMS consolidated trade reporting system of the identity of any ATS that executes a trade in any NMS security.

Block-size orders and trades would, however, be generally excluded from the proposed changes.

While both the SEC and the media have characterized the Proposal as designed primarily to increase the transparency of “dark pools,”<sup>2</sup> the Proposal’s reach is much broader.<sup>3</sup> As noted by the SEC and discussed further below, the Proposal would impact market makers that send IOIs deemed to be “actionable.” Of potentially much greater significance, however, the Proposal may

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<sup>1</sup> Exchange Act Release No. 60997 (November 13, 2009) (the “Proposing Release”) at 1.

<sup>2</sup> The Proposal uses the term “dark pool,” to “refer to [alternative trading systems] that do not publicly display quotations in the consolidated quotation data.” *Id.*, at 6.

<sup>3</sup> See SEC Press Release 209-223 entitled “SEC Issues Proposals to Shed Greater Light on Dark Pools”, available at <http://www.sec.gov/news/press/2009/2009-223.htm>; see also, e.g., Forbes: SEC Fights Dark Pool Abuses, available at <http://www.forbes.com/2009/11/17/sec-dark-pools-markets-equities-regulations.html>, Bloomberg: SEC May Force More Disclosure About ‘Dark Pools,’ Shapiro Says, available at <http://www.bloomberg.com/apps/news?pid=20601103&sid=a8GQ7kkbNAdc>.

subject broker-dealers that send deemed “actionable” IOIs but that are not registered as market makers to the requirements of Regulation ATS. Practical concerns also arise as a result of the Proposal. For example, how should an IOI that the SEC deems actionable, which does not include an explicit price and/or size term, be publicly displayed in the consolidated quote data stream?

Public comment on the Proposal should be submitted to the SEC by February 22, 2010.

## I. IOIs

Deemed Actionable IOIs. The Proposal would amend the definition of “bid” or “offer” in Rule 600(b)(8) of Regulation NMS<sup>4</sup> to apply explicitly to those IOIs deemed actionable by the SEC. As noted in the Proposal, the terms “bid” and “offer” are central to the determination of whether market makers, in the case of Rule 602 of Regulation NMS, or ATSs, in the case of Rule 301(b)(3) of Regulation ATS,<sup>5</sup> must include their trading interest in the NMS consolidated quotation data stream.

While neither the Proposal nor the proposed rule amendments actually define the term “actionable,” the Proposal would provide that an IOI would be considered actionable if it conveys the following information about available trading interest at the IOI sender: (1) symbol; (2) side (buy or sell); (3) a price that is equal to or better than the NBBO . . . and (4) a size that is at least equal to one round lot, whether such information is conveyed “explicitly or **implicitly.**”<sup>6</sup> (Emphasis added.)

The Proposal states that the determination of whether an IOI **implicitly** conveys the above information must take into account “all of the facts and circumstances surrounding the IOI . . . including the course of dealing between the IOI sender and the IOI recipient.”<sup>7</sup> The Proposal makes it clear that where the delivery and receipt of IOIs is part of a course of conduct between two parties, the facts and circumstances approach will likely lead to a determination by the SEC that the IOI is actionable. This follows from the fact that the symbol and side will generally be explicitly communicated while the “IOI recipient reasonably can assume that the price associated with the IOI is the NBBO or better.”<sup>8</sup> Moreover, a recipient that has responded with orders and “repeatedly received executions at the NBBO or better with a size of at least one round lot” can also infer that a size of at least a round lot is being offered.<sup>9</sup>

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<sup>4</sup> 17 CFR 242.600 et seq.

<sup>5</sup> 17 CFR 242.300 et seq.

<sup>6</sup> The Proposing Release at 18.

<sup>7</sup> Id.

<sup>8</sup> Id. at 12 and 13.

<sup>9</sup> Id.

Obligations of Exchange Members and OTC Market Makers. Currently, exchange members and certain OTC market makers are required to provide their “best bids” and “best offers” to their respective exchanges or association pursuant to Rule 602(b) of Regulation NMS. Because the present definition of “bid” and “offer” in Rule 600(b)(8) specifically excludes “indications of interest,” it follows that exchange members and OTC market makers are not currently required to reflect IOIs in the bids or offers that they provide to their respective exchanges or association. As a result, the NMS’s consolidated quotation data stream does not reflect IOIs. The Proposal would change this by limiting the exclusion for “indications of interest” to those “that are not actionable.”

The Proposal does not, however, state its expectations with respect to how terms such as size or price that are likely to be implicitly conveyed should be expressed. For example, may senders of actionable IOIs that do not include an explicit price or size treat the IOI as a quote for one round lot at the national best bid or offer?

Exclusion for Block IOIs. The Proposal would exclude an IOI from the definition of “bids” and “offers” in Rule 602(b) of Regulation NMS where the IOI is for a quantity of NMS stock having a market value of at least \$200,000, but only to the extent the IOI is communicated to those “who are reasonably believed to represent current contra-side trading interest of at least \$200,000.”

Impact of this Change. In addition to the obligation to include deemed actionable IOIs in the bids and offers they provide (and to change their quote when the IOI is filled or withdrawn), market makers would also need to monitor that their actionable IOIs do not lock or cross the market in violation of Rule 610(d) of Regulation NMS.

In addition, non-market making firms that frequently send IOIs in particular names would be required to consider whether they might be viewed as holding themselves out as willing to buy or sell NMS stocks for their own accounts on a regular or continuous basis and, thus, whether they fall within the definition of “market maker” for purposes of Regulation NMS and the Exchange Act generally.<sup>10</sup>

Obligations of ATSS. Currently, as discussed in the following section of this Memorandum, an ATS that meet certain conditions is required to report its “best priced orders” to FINRA pursuant to Rule 301(b)(3) of Regulation ATS. As noted in the Proposal, the term “order” includes, but is not limited to, “bid or offer quotations,” which term is considered by the SEC to have the same meaning as the terms “bid” or “offer” in Rule 600(b)(8) of Regulation NMS.<sup>11</sup>

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<sup>10</sup> See Section 600(b)(52) of Regulation NMS (defining the term “OTC Market Maker”) and Section 3(a)(38) of the Securities Exchange Act of 1934 (defining the term “market maker”).

<sup>11</sup> See the Proposing Release at 17.

As noted in the Proposal, the term “order” as used in Rule 301(b)(3) is defined more broadly than “bids” or “offers” to mean “any firm indication of a willingness to buy or sell a security”. As a result, and as discussed in the Regulation ATS adopting release,<sup>12</sup> Rule 301(b)(3) as currently written arguably already reaches “firm” IOIs, which, in turn, under current law, may or may not be the same as an “actionable” IOI.<sup>13</sup> Because Rule 301(b)(3) includes “bids” or “offers” within its scope, the Proposal’s change to the definition of “bids” and “offers” under Rule 600(b)(8) would also remove all doubt as to whether Rule 301(b)(3) reaches “actionable” IOIs.

Impact of this Change. As discussed in the following section of this Memorandum, this change could impact existing ATSs to the extent they meet the additional conditions set forth in Rule 301(b)(3).

More significantly, and entirely absent from the Proposal, the proposed change to Rule 600(b)(8) would also impact the scope of the definition of “ATS,” which is set forth in Rule 300(a) of Regulation ATS. Consequently, broker-dealers that send actionable IOIs with respect to their customer orders might find themselves subject to the ATS registration requirements.

Rule 300(a) of Regulation ATS provides, in essence, that an alternate trading system is any entity or system that performs the functions commonly performed by a stock exchange. In turn, Rule 3b-16 states that, in essence, a stock exchange (i) brings together “orders” for securities of multiple buyers and sellers<sup>14</sup> and (ii) “uses established, non-discretionary methods . . . under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade.”

Significantly, Rule 3b-16 specifically provides that the entering of orders for execution against the bids and offers of a single dealer does not constitute acting as an exchange. This is true even where the single dealer does not execute the order itself but, instead, matches orders, but only to the extent that the orders are not displayed to any person other than the dealer and its employees, except that in the case of a registered market maker, customer limit orders can be displayed and customer orders can be matched against such limit orders.

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<sup>12</sup> Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) (“Regulation ATS Adopting Release”).

<sup>13</sup> The Regulation ATS Adopting Release notes that the “[a]t a minimum, an indication of interest will be considered firm if it can be executed without the further agreement of the person entering the indication. Even if the person must give its subsequent asset to an execution, however, the indication will still be considered firm if this subsequent agreement is always, or almost always granted. . . .” The Regulation ATS Adopting Release at 63 FR 70844 at 70850.

<sup>14</sup> As noted in the ATS Approving Release, “the mere interpositioning of a designated counterparty as riskless principal for settlement purposes after the purchasing and selling counterparties to a trade have been matched would not, by itself, mean that the system does not have multiple buyers and sellers.” The ATS Approving Release at text following note 42.

As an initial matter, it should be noted that the term “order” in Rule 3b-16 is the same as the term “order” in Rule 301(b)(3).<sup>15</sup> Accordingly, the change in the meaning of the term “order” that would result from the amendment of Rule 600(b)(8) of Regulation NMS should apply equally to Rule 301(b)(3) and Rule 3b-16.

Assuming adoption of the Proposal’s amendment to Rule 600(b)(8) of Regulation NMS, the single dealer exclusion provided by Rule 3b-16 might no longer be available to non-registered market makers that used actionable IOIs to find the other side of a customer order. In other words, a broker-dealer that is not registered as a market maker and that uses actionable IOIs to find the other side of a customer order would, arguably, be performing the functions of a stock exchange, unless the broker-dealer were not using “established, non-discretionary methods.”

While it is not, entirely clear what is meant by “established, non-discretionary methods,” it seems likely from the examples set forth in the ATS Approving Release that satisfaction of this standard does not require formal, written rules but that it would be enough if there is a method that is consistently applied.<sup>16</sup> Accordingly, it seems at least arguable that a broker-dealer that uses actionable IOIs to find the other side of a customer order, and, upon receipt of a response, presents that response to the customer, may be deemed to be performing the functions of an exchange within the meaning of Rule 3b-16 and, as a result, would fall within the definition of, and be subject to the rules regulating, an ATS.<sup>17</sup>

The above conclusion would also significantly impact the SEC’s cost benefit analysis as set forth in the Proposing Release as such analysis entirely fails to consider the possibility that the SEC’s proposed amendment to Rule 600(b)(8) of Regulation NMS might not only affect existing ATSs but might actually force a significant number of broker-dealers that use IOIs to find the other side of customer orders to either cease such practice or to register as ATSs.

## II. The Order Display Obligation of ATSs

Currently, Rule 301(b)(3) of Regulation ATS only requires ATSs to display their orders in the NMS’s consolidate quotation stream if the ATS satisfies both of the following two conditions:

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<sup>15</sup> See the Proposing Release at Note 36.

<sup>16</sup> Otherwise, there would be no need to specifically exclude, as the ATS Approving Release does, traditional block trading desks on account of the fact that the broker-dealer involved therein is exercising discretion, since such desks do not conduct their operations with their counterparties pursuant to formal, written rules.

<sup>17</sup> Though, arguably, if actionable IOIs were sent to a single recipient at a time, the sending broker-dealer would not be subject to the reporting requirements under Rule 301(b)(3) of Regulation ATS, since such order would never be disclosed to more than one person at a time.

1. The applicable order must be “displayed to more than one person in the alternate trading system”<sup>18</sup> and
2. The ATS must have an average daily trading volume of 5% or more of the aggregate daily share volume for the applicable NMS stock “[d]uring at least 4 of the preceding 6 calendar months.”

The Proposal would make two changes to the above conditions. The first condition would only apply if the applicable order was not displayed to more than one person (other than employees of the ATS) regardless of whether those persons were or were not “in the alternate trading system.” The second condition would only apply if the trading volume exceeded 0.25% rather than 5% during the applicable period.<sup>19</sup>

Access to the Displayed ATS Quote. An ATS would also be required to provide execution access to any displayed orders in accordance with Rule 301(b)(3)(iii). As a result, the ATS would be required to provide broker-dealers that are not participants in the ATS with the ability to effect a transaction with the displayed order that is equivalent to their ability to effect orders displayed on the exchange or association to which the broker-dealers have access.<sup>20</sup>

Exclusion for Block Orders. The Proposal would not require display of an order for a quantity of NMS stock having a market value of at least \$200,000, provided the order is communicated only to those “who are reasonably believed to represent current contra-side trading interest of at least \$200,000.”

### III. Trade Reporting Obligation of ATSs

Currently, while ATSs report their trades to one of the joint-industry plans that disseminate consolidated trade data, their trades are identified as OTC trades with no identification of the particular broker-dealer or ATS that reported the trade. The Proposal’s third change would amend

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<sup>18</sup> The condition allowing display to one person was meant to allow the originator of an order to negotiate the order’s execution with a single participant in the ATS without requiring the original quote to be displayed in the consolidated quotation stream. See the Proposing Release at Note 75.

<sup>19</sup> As noted in the Proposal, customers of dark pools would continue to be entitled to control the display of their buying or selling interest in the consolidated quotation data stream but would not be able to consent to the dissemination of actionable IOIs while withholding the quote information from public display in the consolidated quote data stream. See the Proposal at text at Notes 40 to 42.

<sup>20</sup> Significantly, however, the Proposal does not provide for a change in the 5% threshold applicable to an ATS’s obligation under Rule 301(b)(5) of Regulation ATS to provide fair access to its quotes generally. See the Proposing Release at Note 80.

the joint-industry plans to require real time disclosure of the identify of any executing ATS in the NMS's consolidated trade data stream.

Exclusion for Block Trades. Trades for a quantity of NMS stock having a market value of at least \$200,000 would be exempt from the foregoing requirement and, therefore, would continue to be reported as OTC trades without an ATS identifier.

#### IV. On the Horizon

The Proposal comes on the heels of an SEC proposal to eliminate the flash order exception from Rule 602 of Regulation NMS<sup>21</sup> as well as the announced intention of the SEC Chairman, Mary Shapiro, to seek public comment on a host of market structure issues including co-location, the rules governing ATSs, sponsored access, high frequency trading and dark liquidity in all its forms, including internalization, dark order types on exchanges and ECNs.<sup>22</sup> More generally, Chairman Shapiro has also announced a need for the SEC "to consider whether there are additional legislative authorities needed to address new types of market professionals whose activities may not be sufficiently regulated."<sup>23</sup>

The breadth of the SEC's planned review, and the number of issues that it wishes to re-consider, coming so soon after its recent overhaul of the equity markets in the form of Regulation NMS, raise a question as to whether the SEC is attempting to micro-manage the direction and structure of the equity markets to an inappropriate degree.

For many years, the SEC had appeared to favor a market structure that relied upon floor-based, in-person markets, even where the rest of the world had largely moved to electronic markets. Arguably, the SEC's disfavor of electronic trading venues served as more of an impediment to the development of a modern (electronic) market than it did as an impetus. Now that the SEC has acknowledged that trading markets are inevitably electronic, and that speed of execution is a priority, the SEC continues to maintain its confidence that it can force the structure of the market into a shape that is materially better than the shape that the market would naturally take of its own accord. Even assuming that the SEC's approach is broadly correct, it still remains to be seen whether its apparent move towards "a one size fits all" approach to market structure may do more harm than good by eliminating specialized markets and market practices. Further, coming so soon

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<sup>21</sup> Exchange Act Release No. 60684 (September 18, 2009), 74 FR 48632 (September 23, 2009).

<sup>22</sup> See Speech by SEC Chairman Mary Schapiro, "The Road to Investor Confidence" (October 27, 2009) available at <http://www.sec.gov/news/speech/2009/spch102709mls.htm>.

<sup>23</sup> Id.

after the adoption of Regulation NMS, it is open to question whether further changes to the rule should be a priority or whether the SEC's resources are better used elsewhere.

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