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Trade talk: SEC facing thorny issues with flash trading, dark pools, naked access

By Christopher J. Keller and Michael W. Stocker

Regulators have long been concerned with ensuring that investors stand on an equal footing with respect to their access to information about publicly traded companies. However, rapid technological innovation in the markets, including "flash trading," "dark pool" markets and "naked access" is challenging traditional notions of fairness and are posing thorny new problems for the Securities and Exchange Commission.

Flash trading evolved from a regulatory exemption allowing an exchange to offer information regarding trades, in return for a fee, to a select group of market participants just seconds before offering it to other investors. Flash trading became enormously popular with the advent of lightning-fast computers that permit traders with access to flash information to profit by purchasing shares just seconds before large orders drive up the price of a stock, a practice akin to old-fashioned front-running. Institutional shareholders and other large investors have raised concerns that these practices inflate the prices of stock they purchase.

Dark pool markets are automated trading venues that enable trade orders to be filled anonymously. These venues allow the matching of large blocks of purchase and sale orders without prices being revealed until after trades are completed, and provide institutions seeking to buy and sell large blocks of stock with safe places to execute such trading. While some analysts have raised concerns that dark pool markets hamper price discovery, these venues may actually help institutional investors avoid the price premiums they pay as a result of flash trading.

So-called naked access or sponsored access allows some firms to trade directly on exchanges using powerful computers without exchanges or regulators knowing who is making the trades. Naked access avoids the expenses of paying for exchange access and has spread in recent years along with high-speed trading. The SEC is increasingly concerned that naked access poses a threat to financial stability in that neither the broker nor the exchange have any duty to implement technology that would allow for the correction of problems if a series of rapid orders went wrong, potentially leading to the destabilization of the markets.

The SEC is moving swiftly to ensure that this rapidly evolving trading technology works for the markets, not against them. However, its task will not be easy, and regulation not carefully thought through might have unintended consequences.

Perhaps the easiest target for regulators is the problem of flash trading. On Sept. 17, SEC commissioners voted unanimously to propose a rule that would prohibit all markets from displaying marketable flash orders. While proponents of flash trading urge that it increases liquidity in the markets, there can be little debate that the practice is not in the interests of investors whose orders are being front-run.

Dark pools: trickier to regulate

More problematic is the SEC's consideration of changes in the regulatory structure governing dark pools, announced Oct. 21. At the moment, dark pools take advantage of the fact that so long as trades occupy less than 5% of the total trading volume of a stock, they do not have to be reported. The new regulations would change the 5% limit to 0.25%, thereby exposing many more trades to public scrutiny. Another proposal would require that dark pools make public any "indication of interest", or IOI, they receive of an entity's interest in performing a trade; in the future, these IOIs would be opened to the general market and treated like any other market quote and subject to the same disclosure rules. Finally, a proposed regulation would require real-time identification of the dark pool that executed a trade so that the public has a better idea where trading actually takes place.

While dark pool markets raise legitimate concerns about transparency, regulators should be cautious about moving too quickly. Because large investors often resort to the anonymity of dark pool markets in part to avoid the share price premium that results from the activities of flash traders in the public exchanges, reforming dark pools without first reforming flash trading may only amplify transaction costs.

It remains to be seen whether the SEC will take regulatory action with respect to naked access. The commission has indicated that it expects exchanges to act quickly in imposing their own structural safeguards, but that if these changes do not come quickly enough, the SEC may impose its own rules. Rules that the SEC might consider include a requirement that naked access users submit to pre-trade order checks monitored by the brokerage firm.

Investors would be wise to pay careful attention to these fast-breaking developments regarding the regulation of trading innovations. Without careful rulemaking, trading may be entering a new world in which access to technology rapidly replaces investor acumen as the key to profits. ■

Christopher J. Keller is a partner at Labaton Sucharow LLP, a New York-based class-action law firm. He concentrates his practice on securities class-action litigation in federal courts. Michael W. Stocker, attorney with Labaton Sucharow, represents clients in commercial litigation, focusing primarily on antitrust and securities class-action matters.