Dark Pools and the Decline of Market Governance

Yesha Yadav

Discussion by Pab Jotikasthira
SMU

Summary

Reg. ATS ushered in the new era of fragmentation in the US stock market. This paper …

- Argues that exchanges (and ATS) **exercise less oversight** to minimize **fraud and manipulation**.
  - Extremely costly and logistically difficult due to fragmentation and lack of transparency/information sharing.
  - Minimal incentives to govern as costs are privately borne while benefits are shared among venues → Free-riding problem.
- Proposes that immunity be invoked and **exchanges/ATS be held liable for oversight failures**.
  - Collective liabilities disbursed from a shared fund promotes self-policing and co-operation among trading venues.

My Thoughts

I learned a lot! Very comprehensive (though repetitive at times) review of history and various intents in establishing the market system.

- Clearly articulates governance challenges induced by fragmentation.
- Proposes a thoughtful and implementable solution.

From my financial economics point of view, the following issues are not clear.

- Is there really a decline in governance?
- Does Dark vs. Lit really matter? Or, just fragmentation?
- FINRA and potential redundancy.

1. Decline in Market Governance?

- **Both operations and economics** suggest that exchange oversights should decline due to fragmentation.

- Any evidence?

- All examples of fraud and manipulation given in the paper seem to come from derivatives exchanges (CME and CBOE).
  - **Profit maximization by exchanges** seems to be the cause there, not fragmentation.

- Other examples, such as Barclays (or similarly ITG's front running), are **misbehaviors by the ATS themselves** not by the traders who use the platform.
  - This is a different issue, not to be confused with trading oversight.

2. Do Dark Pools Really Matter?

- Imagine a world with 40+ exchanges, rather than 10 exchanges and 30 dark pools?
  - Would the operational and incentive challenges for oversight be any different?
  - **Fragmentation** seems to be the main cause, **not dark vs. lit.**
- To convince readers, give <u>examples of manipulation or frauds that only occur undetected in presence of dark pools</u>:
  - Traders can trade under different accounts and conceal their intent even in lit venues.
- If ATS, being lightly regulated, have such a big advantage over exchanges, why did IEX upgrade to become an exchange?

3. FINRA and Redundancy

- Economists tend to think that over-regulation is potentially as bad as under-regulation.
  - True that ex-post liabilities induce the right ex-ante incentives.
  - **The proposal doesn't fix the high costs of oversight** in fragmented markets, so a more oversight can mean higher fees and transaction costs for traders.
- Trade information **already consolidated at FINRA**.
  - FINRA currently focuses on ensuring best execution (Order Protection Rule).
  - Seems **more economical to simply charge FINRA with additional responsibility** for detecting frauds and manipulation.

Conclusion

- **Comprehensive analysis** of governance problems in today's fragmented stock markets.
  - ✓ Clearly articulates economic forces at play.
  - ✓ Proposes an implementable solution.

- My questions.
  - ❑ In practice, do we really observe a decline in governance?
  - ❑ If so, is it due to the proliferation of dark pools or simply fragmentation?
  - ❑ If so, is it not less costly to delegate governance role to FINRA?