Dark Pools and the Decline of Market Governance

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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 examples of manipulation or frauds that only occur undetected in presence of dark pools:
  – 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?