Dark Pools and Market Governance

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The plunge of May 6

Relative performance\(^a\):
- Procter & Gamble
- S&P 500
- Nasdaq
- Crude
- Dollar index

\(^a\) Rebased: May 6 2010, 1:45 p.m. = 100
Source: Thomson Reuters

REUTERS
The Regulatory Role of Exchanges

• Exchanges have wide delegated regulatory authority in securities regulation to monitor markets, enforce laws and maintain high standards of behavior.

• Exchanges oversee the organization of public companies as well as traders that transact in the secondary markets.

• Historically, this delegation of authority has made sense in markets where exchanges consolidate a large swathe of trading activity in their institution.

• Exchange oversight bring expertise and experience to regulation. Additionally, discipline bites when exchanges can exclude players from a key resource.
Modern Market Design

• Regulatory policy in the E.U. and the U.S. has sought to introduce greater competition in the provision of trading services.

• Regulation National Market System (Reg NMS) requires that equity trades be executed at the best available price in the market.

• MiFID opens up the market for trading services to competition and introduces multilateral trading facilities (MTFs) and removes the concentration rule.

• Regulation Alternative Trading Systems allows lightly-regulated, non-exchange venues – or dark pools – to compete to offer trading services.
Fragmentation

- Equity trading is heavily fragmented. In the U.S., equity volume is divided between 13 public exchanges and around 40 ATS or dark pools.

- Whereas exchanges like the NYSE consolidated around 80% of secondary trading in the securities they listed, this figure is now closer to around 20-25%.

- Dark pools enjoy an increasing share of equity trading year-on-year, with some estimates suggesting that dark pools dominate around 40% of all share volume.

- Trading costs are sharply down, with exchanges are charging much lower fees.
Impact on Regulation

• Fragmentation creates high hurdles for exchanges to discharge their responsibility to oversee markets.

• Information asymmetries are now institutionalized within market structure, with traders free to transact across around 50 platforms with varying transparency.

• Exchange discipline has less bite where traders can move to another, less regulated venue.

• Exchanges and dark pools must now co-operate in order to figure out instances of wrongdoing in providing oversight.
Distorted Incentives to Oversee Markets

- In competitive, fragmented markets, exchanges and dark pools have limited incentives to oversee markets and to co-ordinate on oversight.

- Fragmentation deepens the conflicts of interests intrinsic to relying on for-profit exchanges to oversee markets.
- In losing business to other venues, exchanges are generating revenue by selling a variety of other products and services.
- Further, by enforcing strictly on their venues, exchanges confer value on their competitors and may lose business themselves by the fact of tough oversight.
- Further, exchanges can gain by under-investing in oversight. They win by attracting business. But they can transfer risk to other competing venues.
Economic Consolidation

• The Article argues for greater use of liability levers to fill the deficit in oversight left by fragmentation in modern markets.

• It argues for exchanges and dark pools to face stronger liability for their failures in oversight. Exchanges would no longer enjoy qualified immunity.

• In addition, to encourage exchanges and dark pools to monitor each other, the Article also makes the case for an industry Disruption Fund financed by venues.

• The Fund would encourage greater economic consolidation while leaving exchanges and dark pools to compete on the provision of trading services.
Thank you!

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