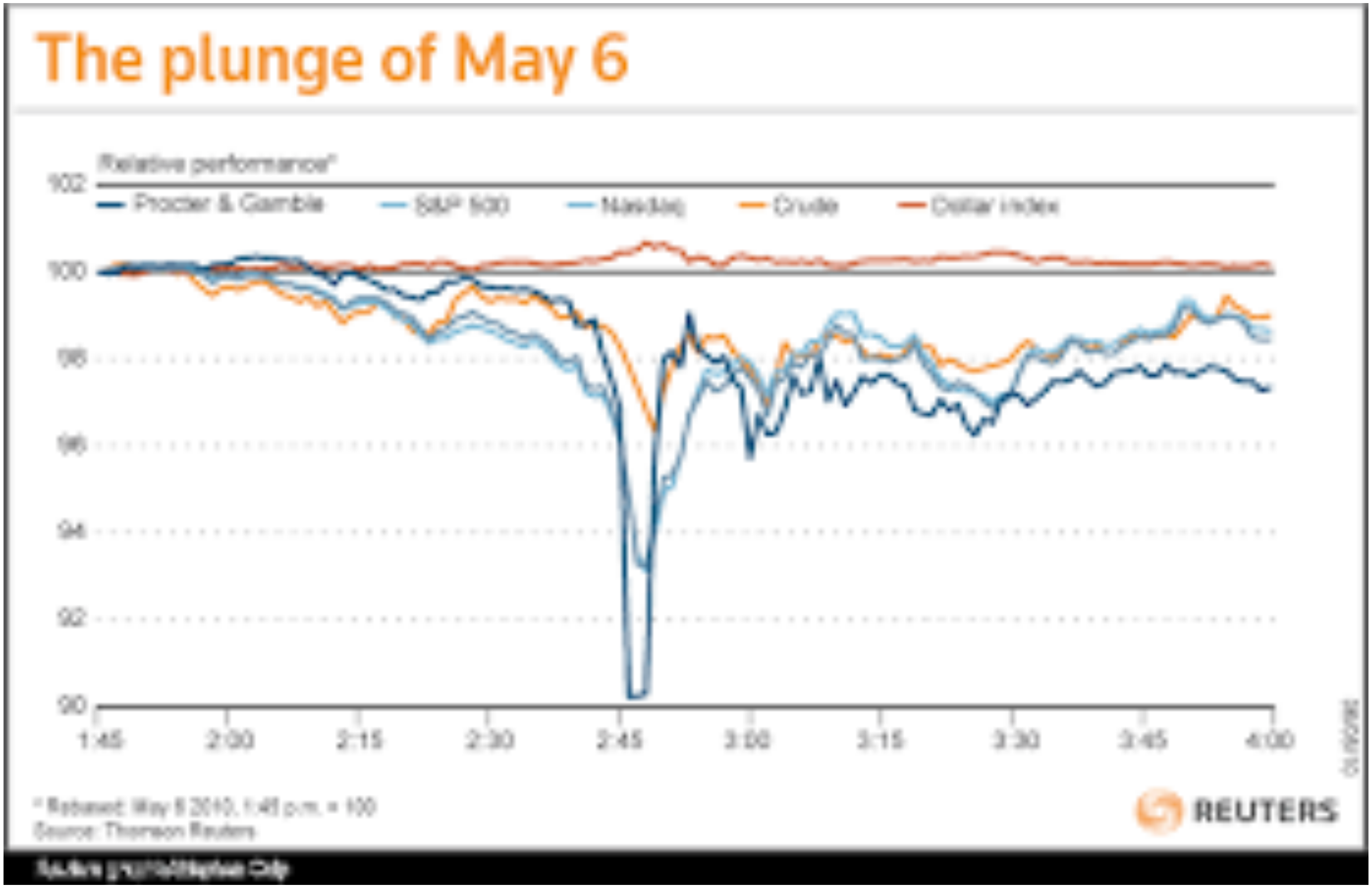
Dark Pools and Market Governance

Yesha Yadav, Vanderbilt Law School

IGIDR/Vanderbilt Law School EMF 2017



The plunge of May 6
Relative performance*
Procter & Gamble
S&P 500
Nasdaq
Crude
Dollar index
102
100
98
96
94
92
90
1:45
2:00
2:15
2:30
2:45
3:00
3:15
3:30
3:45
4:00
Source: Thomson Reuters
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!

Paper:
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2754786