

February 1, 2011

Mr. Werner Bijkerk
Senior Policy Advisor
International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
28006 Madrid
Spain

Re: Public Comment on Issues Raised by Dark Liquidity

Dear Mr. Bijkerk:

The Securities Industry and Financial Markets Association (“SIFMA”)¹ and the Association for Financial Markets in Europe (“AFME”)² welcome the opportunity to comment on the Technical Committee (“Committee”) of the International Organization of Securities Commissions (“IOSCO”) Consultation Report regarding Issues Raised by Dark Liquidity (“Report”).³ We appreciate the timeliness of the Committee’s review of the various regulatory issues raised by dark liquidity, and we are pleased to comment on the five Topics set forth in the Report.

As a general matter, we believe that dark liquidity, including internalization practices of broker-dealers, provides genuine benefits to the markets and their participants (including intermediaries and professional and retail investors) without detracting from the overall vibrancy of displayed markets. For example, as the Committee is aware, dark liquidity often is used by market participants seeking to avoid adverse market impact when executing their trades. In addition, internalized executions by broker-dealers, in particular, provide investors – often retail investors – with speedy executions and, frequently, price improvement, mainly because broker-dealers retain control over the order execution process.

¹ The Securities Industry and Financial Markets Association (“SIFMA”) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (“GFMA”). For more information, visit www.sifma.org.

² The Association for Financial Markets in Europe (“AFME”) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME provides members with an effective and influential voice through which to communicate the industry standpoint on issues affecting the international, European, and UK capital markets. AFME is the European regional member of the Global Financial Markets Association (GFMA). For more information, visit the AFME website, www.AFME.eu.

³ Issues Raised by Dark Liquidity, Consultation Report, Technical Committee of the IOSCO (Oct. 2010) (“Report”).

Moreover, we believe that the availability of dark liquidity has not impaired price discovery or execution quality in the U.S. or in Europe. To the contrary, displayed markets remain healthy. Indeed, the most recent studies we have seen regarding the U.S. markets demonstrate that the availability of dark liquidity venues has not, in fact, adversely impacted the displayed markets. For example, a very recent working paper on the impact of dark pools on U.S. market quality concludes that “a higher amount of dark pool activity is associated with lower quoted and effective spreads, lower price impacts, and lower short-term volatility. In other words, more dark pool activity is generally associated with higher market quality.”⁴

The conclusions of this research are borne out by our experience with the U.S. and European markets. In the U.S., we note, for instance, the prevalence of very narrow spreads in national market stocks, indicating that effective and efficient price discovery is occurring in the public markets.⁵ In addition, by protecting the top of book of U.S. trading centers, the Securities and Exchange Commission’s (“SEC”) Order Protection Rule (Regulation NMS Rule 611), which prohibits trade-throughs, is an effective supplement to the duty of best execution in policing execution quality.⁶ Studies also indicate there have been improvements in depth of book display beyond the national best bid or offer (“NBBO”).⁷ These trends have occurred concurrent with the growth of alternative trading systems – which have offered significant opportunities for price improvement to their end users, including firms representing retail investors – as a percentage of all dark liquidity venues.

In light of the evidence to date, we believe that market participants should have the ability to utilize dark liquidity to facilitate their trading and that such dark liquidity would not adversely impact the U.S. and European markets. We acknowledge, however, that market structures and practices will continue to develop and may vary across jurisdictions. Therefore, we believe that it is critical that regulators, academics, market participants and other interested parties continue to perform empirical analyses of the effect of dark liquidity on transparent markets before making market structure changes that impede or limit the use of dark liquidity by broker-dealers and other market participants. Such analysis would allow lawmakers and

⁴ Sabrina Buti, Barbara Rindi and Ingrid M. Werner, *Diving into Dark Pools*, Fisher College of Business Working Paper (available at http://fisher.osu.edu/fin/faculty/werner/working_papers.htm).

⁵ See O’Hara, Maureen and Mao Ye, *Is Market Fragmentation Harming Market Quality?* (Mar. 2009), 19, (available at <http://ssrn.com/abstract=1356839>) (“In the post-Reg NMS world, effective spreads are extremely low, with average spreads in the 3-4 cent range. Turning to our specific hypothesis, the data show that effective spreads are lower in the fragmented sample on average by .29 cents with median spreads lower by .11 cents.”).

⁶ We understand that the Committee’s mandate “does not cover issues relating to how best execution is to be met in relation to dark liquidity.” Report at 5. However, we believe it is important to recognize that best execution is a key factor in determining the appropriate regulatory response to the use of dark pools.

⁷ Angel, James J., Lawrence E. Harris, Chester S. Spatt, *The Economics of Trading in the 21st Century* (Feb. 23, 2010), 15 (available at <http://www.knight.com/newsRoom/pdfs/EquityTradinginthe21stCentury.pdf>). See also Yossi Brandes and Ian Domowitz, Investment Technology Group, Inc., *Alternative Trading Systems in Europe: Trading Performance by European Venues Post-MiFID* (May 2010) (available at http://www.itg.com/news_events/papers/ITG-Paper-AlternativeTrading-051910F.pdf) (concluding that European dark pools add value to their users by lowering transaction costs and reducing slippage).

regulators to accurately calculate the level of riskless principal and principal trading that occurs in the over-the-counter markets, and to respond appropriately to that knowledge. The need for a clearer understanding of dark liquidity and other over-the-counter trading is particularly acute in Europe where there is a general perception that circa 40 percent of European equities trading is the result of bilateral trades with clients and broker-dealers which could be moved directly onto the lit markets. In reality, the “OTC trades” percentage includes a vast number of technical trades that are required to be reported but form no part of price formation (*e.g.*, “give-up/in” trades between executing broker and prime broker) or which do not represent liquidity available to other market participants (*e.g.*, “risk facilitation” trades for clients which will subsequently be unwound in the market). In a January 24, 2011 paper entitled “Breaking Down the UK Equity Market: Executable Liquidity, Dark Trading, High Frequency and Swaps,” the TABB Group “...estimates that while OTC-reported turnover accounts for 45% of the market, less than a quarter of it is executable. The balance, says [TABB], is in fact comprised of reprints of already-traded turnover with 72% of executable liquidity being traded on the lit order book of an exchange or multilateral trading facility (MTF).”

Specific Topics

1. Topic 1: Transparency to Market Participants and Issuers

a. Pre-Trade Transparency

In Principle 1, the Committee states that “[t]he price and volume of firm bids and offers should generally be transparent.” We believe that Principle 1’s focus on the need for pre-trade transparency fails to appropriately recognize the value that dark liquidity provides to the markets. Dark liquidity plays an important role in the investment trading process, in ensuring market efficiency, and in price formation.⁸ As such, the use of dark liquidity, when properly regulated, will continue to be beneficial to investors of all types. Therefore, we urge the Committee to amend Principle 1 to specifically recognize the positive role that dark liquidity plays in the marketplace as well as the fact that different levels of pre-trade transparency may be appropriate for different market structures or order types.

The Principle’s proposed general pre-trade transparency requirement reflects a concern that dark liquidity impairs price discovery and provides disincentives to publicly display

⁸ As the former Director of the SEC’s Division of Trading and Markets, Erik Sirri, said,

“... dark pools of liquidity have been around for a long, long time. The single largest dark pool in the world for many decades could be found on the trading floor of the New York Stock Exchange. The floor traders there manually represented a pool of undisplayed liquidity that could be accessed only by sending an order to the floor to probe buying and selling interest. ...Dark pools are solutions to a perennial trading dilemma for anyone that needs to trade in substantial size, particularly institutional investors. They provide a mechanism for such transactions to interact without displaying the full scale of their trading interest. Today, nearly every equity trading venue in the U.S. offers some sort of dark liquidity.”

Speech by Erik Sirri at SIFMA 2008 Dark Pools Symposium, February 1, 2008.

quotations. These concerns appear to be based on the assumption that the use of non-displayed liquidity diverts order flow away from the public quoting markets, thereby adversely affecting the execution quality for those market participants that display their orders in the public markets. Based on history and practice in the U.S. and Europe, we believe these fears are unfounded or, at least, should be tested empirically.

First of all, there is no economic incentive for all (or most) liquidity to go dark. Trading professionals, particularly those with large orders that are likely to have a significant impact on the market (*e.g.*, orders for money managers that oversee collective pools of assets contributed by individuals), always have a dual focus when seeking best execution of their orders: displaying a quote to achieve a more certain execution (with the risk of moving the market adversely) versus not displaying a quote in an attempt to reduce market impact and potentially obtain price and/or size improvement. This natural “give and take” between certainty of execution (and eliminating “opportunity cost risk”) and managing market impact (with attempted price/size improvement) works to maintain equilibrium between non-displayed and displayed liquidity.

Indeed, such equilibrium generally has been maintained over the years, even as non-displayed liquidity has evolved from a manual process to more automated solutions. For example, since the early years of the New York Stock Exchange and other stock exchanges, there have been floor brokers who worked large orders discreetly in order to obtain the best possible price for investors. In the over-the-counter markets, traders held their trading interest on their desks and used the telephone to call trusted partners to inquire about possible matches. As markets have evolved, new ways of managing this trading process and the risks associated with displaying large trading interest have developed. The growth in the number of alternative trading systems, MTFs, and Broker Crossing Networks (BCNs), for example, can be viewed as a natural and necessary electronic evolution of an age-old process, rather than a new trading concept.

In addition, we note that dark orders and related trading activity are part of the price discovery process. Market participants that use dark orders constantly monitor and respond to displayed bids and offers as well as to last sale and volume traded information (which originates from both displayed and undisplayed order types and markets). Market participants using dark order types display orders when market conditions compel them to shift from passive to more aggressive interaction with the marketplace. For example, when the market price of a security changes or transaction volume is reported to the market (again, whether executed at a displayed market or dark pool), such activity can cause trading behavior to change from passive (*i.e.*, use of undisplayed or partially displayed orders) to active, where a trader will “take” or display liquidity.

In our view, markets and trading technologies naturally evolved considerably over time, becoming more sophisticated and complex; however, the markets have not been adversely impacted by the availability of dark liquidity. Therefore, we urge the Committee to continue to recognize the benefits of dark liquidity to investors. Nevertheless, we support periodic reviews of new trading developments to ascertain their effect on market efficiency and the price

discovery function and to determine whether new or different regulation is needed. As such, we support Principle 1's statement that regulators should consider the impact of new types of dark liquidity on price discovery, fragmentation, fairness and overall market quality.⁹

b. Post-Trade Transparency

With regard to Principle 2, we support the goal of providing post-trade transparency for trades executed in dark pools or as a result of dark orders entered into transparent markets. We also believe, however, that any such post-trade transparency requirements must be balanced against the interests of investors using dark liquidity to minimize market impact when effecting their transactions. In particular – and noting that current trade reporting requirements vary between jurisdictions (for example, Dark MTF trades are reported in real-time with a venue identifier in Europe), we are opposed to the extension of real-time trade reporting of the identity of dark pool operators, including ATs and BCNs, on the basis that this would impose unnecessary risks to market participants seeking the best manner in which to execute their orders. Many large “parent” orders are, in fact, executed as a series of smaller “child” orders in today's markets. Thus, the extension of real-time trade reporting of dark pool operator identities will lead to information leakage that ultimately will harm the ability of users of dark pools to execute orders without market impact.¹⁰

Real-time reporting of the identity of a dark pool operator in trade reports raises more concerns than does identifying executing exchanges on trade reports. Most dark pool operators have a relatively small percentage of overall market share. Many dark pool operators also generally have fairly narrow business models, many with specific matching criteria and specific types of users, as opposed to the more broad business models used by exchanges. The combination of these factors means that sophisticated traders have a greater ability to ascertain information related to the activity in the dark pool – specifically, the kinds of working orders likely to be active in the dark pool at any given time – than they would for an exchange. Therefore, real-time identification of dark pool operators in trade reports would significantly enhance the ability of sophisticated traders to ascertain large orders within such systems, particularly orders in smaller dark pool operators. This information could then be used to trade in a manner to the ultimate detriment of the users of a dark pool. By contrast, the identification

⁹ The Committee notes that “[r]egulators should consider whether it is appropriate to treat actionable indication of interest (“IOIs”) as firm quotes.” We note that the SEC has previously differentiated IOIs and orders by describing IOIs as interest to buy or sell a security where the price, side or number of shares is not always specified, unless the price or size is implied. In other words, an IOI is trading interest that cannot be executed without further interaction between the market participants. We support the continued reliance upon this previously articulated definition of an IOI. However, we urge regulators to clarify and then appropriately enforce the application of this definition to new types of trading interests as they appear. Similarly, we support the European Commission proposal in its MiFID Review Consultation Paper to treat actionable IOIs as orders.

¹⁰ For example, order anticipation strategies employed by proprietary trading firms attempt to ascertain the existence of a large buyer or seller in the market and to trade in the direction of that trading interest. Such strategies may include the use of sophisticated pattern recognition software to ascertain the existence of a large buyer or seller from publicly available information, or the use of orders to “ping” market centers to locate and trade in front of large buyers or sellers.

of exchanges in real-time trade reports is less problematic because the trades are not identified by individual broker-dealer, but instead are attributed to the exchange more generally. It is important to note that, in the U.S. and in Europe (and perhaps in other jurisdictions), the use of non-displaying trading systems is not limited to institutions or broker-dealers representing institutional orders. Rather, all types of order-sending firms within the broker-dealer community, including those handling retail orders, access such trading systems. As a result, the negative impact of providing real-time identifying information regarding dark pool operators will be felt across a broad spectrum of market participants, including retail investors.

Moreover, real-time disclosure of the identity of dark pool operators on trade reports is unnecessary because there are alternatives that would better achieve the transparency goals without inadvertently generating negative consequences for investors. Specifically, we believe that the timing of dark pool trade data disclosure should reflect the liquidity of the securities concerned. For example, we recommend end-of-week reporting of ATS trade data on a symbol-by-symbol basis for each ATS. If end-of-week reporting is deemed insufficient, end-of-day public reporting of the identity of dark pool operators executing trades in relatively liquid National Market System stocks and most European stocks should achieve the regulators' goals while sufficiently protecting dark pool users from adverse market impacts that would result from real-time disclosure of the identity of the dark pool operator in trade reports. For less liquid stocks (*e.g.*, Nasdaq Capital Market stocks), we believe that end-of-week public trade reporting would be necessary because end-of-day trade reporting in such names likely would result in the same information leakage concerns raised by real-time reporting of a dark pool operator's identity in trade reports.

We appreciate that regulators may need increased transparency of the identity of dark pool operators effecting trades to effectively surveil the markets. If the regulators believe that real-time reporting of the identity of dark pool operators executing trades is necessary for regulatory purposes, we would support disclosure of such information to regulators. Our primary concern with any proposal to identify dark pool operators on a real-time basis centers on the negative consequences that likely would attend such reporting to the public. We have no such concerns with respect to the availability of such reports to regulators for oversight purposes.

2. Topic 2: Priority of Transparent Orders

We agree with the general goal of Principle 3 – that is, ensuring that there are adequate transparent orders in the marketplace. However, we believe that such a goal must be appropriately balanced with the recognition of the value of dark liquidity. As such, we would oppose substantial limitations on the use of, or disincentives to use, dark liquidity for the reasons discussed above. While we thus accept that transparent orders should have priority over dark orders on the same order book, we believe that a cross-venue requirement for transparent orders to take priority over dark orders would curtail best execution and disadvantage investors. Instead, we believe the U.S. approach of relying on, among other things, the duty of best execution, the Order Protection Rule, and consolidated market data to incent transparent orders is the better practice. We, therefore, urge the Committee to incorporate into Principle 3 the need to

carefully evaluate the effect of any disincentives to use dark liquidity on the markets and their participants in light of the benefits of dark liquidity (as discussed above).

3. Topic 3: Reporting to Regulators

We support the objective articulated in Principle 4 that regulators should have access to sufficient information about trades executed in dark pools or via dark orders to effectively surveil the markets. As noted above, we would limit the public dissemination of pre-trade information and certain post-trade information related to such dark trading given the likely negative consequences of such information sharing. Reporting such information to the regulators, however, would not raise those same concerns. Therefore, we would support such trade reporting as may be necessary and appropriate for oversight purposes.

4. Topic 4: Information Available to Market Participants about Dark Pools and Dark Orders

We fully support the requirement set forth in Principle 5 for dark pools and transparent markets that offer dark orders to provide participants with sufficient information to understand the manner in which their orders are handled and executed. The benefits of dark trading rely on keeping trading interest confidential; however, this does not mean that participants should be kept in the dark as to the manner of trading itself. Therefore, as the Committee suggests, we would urge dark pools and transparent markets with dark orders to provide participants with detailed information on how trading occurs, to include explanations of priority, the order interaction between dark and transparent liquidity, any use of indications of interest, and who has access to trading information.

5. Topic 5: Regulation of the Development of Dark Pools and Dark Orders

As we note above, we believe that it is critical for regulators to keep abreast of new developments in the markets, and to respond to such developments as warranted. This objective applies as well to dark pools and dark orders. Therefore, we support Principle 6 as articulated by the Committee, and agree that regulators should monitor the development of dark pools and dark orders to seek to ensure that such developments do not adversely affect the efficiency of the price formation process on displayed markets, and take appropriate action as needed.

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We appreciate this opportunity to comment on the issues raised in the Report. If you have any comments or questions, please do not hesitate to contact the undersigned at christian.krohn@afme.eu or avlcek@sifma.org.

Sincerely,

/s/ Christian Krohn

Christian Krohn
Managing Director
AFME

/s/ Ann Vlcek

Ann Vlcek
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cc: Mr. Carlo Comporti, Acting Secretary General
European Securities and Markets Authority

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