

### SECURITIES ENFORCEMENT

# 'Dark Pool' Trading Is Not Shielded From Regulatory Spotlight



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Advances in technology have drastically changed how investors buy and sell securities. Driven largely by the increase in demand for the ability to execute high frequency trading (HFT) strategies, traditional securities exchanges are being displaced by alternative trading systems (ATS). These ATS offer investors several advantages, including improved execution and the ability to trade away from a public exchange using anonymous indications of interest. The rapid pace with which these systems are developing has presented regulators with a significant challenge—to try and create a workable regulatory regime to monitor trading in a highly fluid, increasingly complex environment. This is especially so given that the scale of trading on these ATS amounts at times to as much as 15 percent of all securities trades in the United States.

One ATS that has recently come under regulatory scrutiny is known commonly as a “dark pool.” It is estimated that there are about 50 dark pools currently in operation.<sup>1</sup> Dark pools allows investors—primarily mutual funds and other institutional traders—to trade large blocks of securities in a manner that prevents high-frequency traders from front-running their trades and thus move the market in such a way that makes it difficult to finish the initial trade. Specifically, counterparties to a trade in a dark pool are anonymous to each other and treat the ATS as the counterparty. This allows for the price quotes of the securities to be traded to remain confidential. The value of trading in dark pools, then, is that it permits large institutional investors to maximize profits by being able to execute a trade without the fear of having that trade front-run by a high-frequency trader.

There are, however, several ways in which dark pools can be used to further potentially improper trading motives. One stark example of the potential misuse of dark pools, and the way in which regulators may see the risks they present, is in the recent insider trading complaints

filed by the U.S. Department of Justice and the U.S. Securities and Exchange Commission against Matthew Martoma, former fund manager at SAC Capital Advisors.<sup>2</sup> According to the SEC’s complaint, emails involving Martoma stated that the allegedly unlawful trades were “executed quietly and efficiently over a 4 day period through algos and dark pools and booked into two firm accounts that have very limited viewing access.”<sup>3</sup> It thus appears that a dark pool’s promise of confidentiality could entice traders to employ those systems for unlawful purposes.

As noted above, there are certain aspects—and potential misuses—of dark pools that render them ripe for additional regulation. This article provides an overview of dark pools, how they operate, and how regulators, specifically the SEC and the Financial Industry Regulatory Authority (FINRA), have dealt with and, perhaps more importantly, plan to deal with increased trading in dark pools.

### Basics of Dark Pools

FINRA has defined a dark pool as “an ATS that does not display quotations or subscribers’ orders to any person

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or entity, either internally within an ATS dark pool or externally beyond an ATS dark pool (other than to employees of the ATS).<sup>4</sup> In other words, dark pools provide investors with a similar type of liquidity that they can find on a public exchange, but do so in a private way. Investors who subscribe to a dark pool put in their buy or sell order. The operator of the pool then finds a private counterparty to complete the trade. Historically, dark pools have been used by larger institutional investors, such as mutual funds and large money managers, but HFT firms and hedge funds have recently begun taking advantage of dark pools.

There are a number of benefits to trading in a dark pool, the most critical being the privacy of the transaction. For example, because the dark pool does not reveal price quotations or other information to the public, investors are free to execute trades without risk of moving the market. That is, the trades can be made without any fear of an HFT firm or other trader employing a sophisticated algorithm mimicking the investors' trading strategy and affecting the price of the stock.

## Regulation

Despite the potential benefits to trading in a dark pool, such trading also poses a number of concerns, both related to investors and the markets more generally. Regulation specifically applicable to dark pools has been somewhat limited, but dark pools are required, pursuant to Regulation ATS, to register with the SEC either as an exchange or a broker-dealer.<sup>5</sup> As such, dark pools are subject to the same rules governing trading on an exchange or by a broker-dealer.

In October 2009, the SEC identified the following concerns with dark pools, each of which remain relevant today. The SEC noted that the practice of not

sharing with the public indications of interest and/or price quotations could lead to a "two-tiered market in which the public does not have fair access to information about the best available prices and sizes for a stock that is available to some market participants."<sup>6</sup> Moreover, the SEC also noted that dark pools do not, in all instances, report fully post-trade information which, in the SEC's view, "detracts from the public's ability to assess the sources of liquidity in a stock and dark pool trading activity in general."<sup>7</sup> The latter point was addressed by making each trade in a dark pool immediately reportable, and FINRA has added a rule that any ATS, including dark pools, may also voluntarily report trading data in the aggregate after the market closes.<sup>8</sup>

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Although there was an apparently increased regulatory focus on dark pools in late 2009, some commentators have allocated at least a portion of the blame for the May 6, 2010 "flash crash" on the use of dark pools by HFT firms.<sup>9</sup> A spate of regulation followed the flash crash, but nothing focused specifically on trading in dark pools.

Approximately one year later, on July 11, 2012, the SEC adopted a new rule that requires FINRA and the stock exchanges, among other things, to submit to the SEC—within 270 days from July 11, 2012—a detailed, comprehensive plan for consistently tracking order and execution information.<sup>10</sup> This rule seeks to create what the SEC refers to as a "con-

solidated audit trail" or CAT, which will track order and execution information across the various exchanges and other regulated markets. Although not mentioned specifically, it seems likely that any proposal would presumably capture trading in dark pools and other ATS.

The lack of any direct pronouncement regarding dark pools seems likely to change in the very near future. On Jan. 8, 2013, FINRA pronounced that it planned to increase its focus on dark pools.<sup>11</sup> While FINRA fell short of suggesting a proposed rule for further regulating dark pools, the message was clear: Price quotations and certain other information about the trades taking place in a dark pool may be confidential, but that does not mean the activity is immune to regulatory scrutiny.<sup>12</sup>

Until a specific regulatory regime for dark pools is established, investors and dark pool operators are left to discern rules from the small number of enforcement actions that have been brought in this area. As set forth below, the SEC's Division of Enforcement V has set its sights on how dark pools maintain the confidentiality of trading information, and also made clear that dark pool operators are subject to the same rules and regulations that apply to traditional exchanges and broker-dealers.

## Recent Enforcement Actions

The difficulty of monitoring trading in dark pools has not stopped FINRA or the SEC from doing so. In fact, the SEC's Division of Enforcement has recently brought two actions against dark pools. The varying nature of the allegations in these two recent actions suggest that the division is still working through the potential securities laws violations that could result from trading in dark pools, but one theme is constant: Dark pool operators must maintain the confidentiality of their customers' trading information.

**In the Matter of Pipeline Trading Systems.**<sup>13</sup> Since 2004, Pipeline Trading Systems was a dark pool operator registered with the SEC. According to the SEC, Pipeline described its dark pool to investors as a “crossing network” that provided “natural liquidity” by matching up private buyers with private sellers. In reality, the majority of the orders placed through Pipeline’s dark pool were filled by Pipeline’s parent company, Milstream Strategy Group. In fact, Milstream would trade in the same direction as the Pipeline customers before filling those customers’ orders. Pipeline appeared to have recognized this was a conflict and tried to remedy the problem by paying Milstream’s traders extra for providing Pipeline customers with better prices. The SEC found fault with this as well, as Pipeline never disclosed that it was paying Milstream traders for this service.

Based on the above, the SEC found that Pipeline and two of its executives violated §17(2) of the Securities Act as well as Regulation ATS. Without admitting or denying the allegations, Pipeline paid a \$1 million civil penalty to settle the case. The two Pipeline executives also settled the SEC’s claims by each paying \$100,000 in civil penalties.

The SEC made clear that regardless of where a trade takes place, “one principle remains fundamental—investors are entitled to accurate information as to how their trades are executed.”<sup>14</sup> Thus, it is clear that even though the trades take place away from a public exchange, operators of dark pools must comply with the standard principles of fair trading in the securities market.

**In the Matter of eBX.**<sup>15</sup> In October 2012, the SEC brought its most recent enforcement action against a dark pool operator. eBX operates a dark pool

called “Level ATS.” In reality, despite the representations it made to its customers, eBX was not operating a true dark pool. Investors choose to trade through a dark pool because of the confidentiality and privacy those systems provide. Indeed, the SEC stated this fact plainly in announcing this action, acknowledging that “[d]ark pools are dark for a reason: [B]uyers and sellers expect confidentiality of their trading information.”<sup>16</sup> Rather than maintain the confidentiality of its customers’ orders, eBX sold their trading information—specifically the customers’ unexecuted trade data—to a third-party technology company, which traded on the information for its own benefit.

The SEC alleged that eBX violated Regulation ATS. Without admitting or denying that allegation, eBX paid an \$800,000 civil penalty to settle the matter.

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### Conclusion

The regulatory focus on dark pools, and ATS trading more generally, is expected to heighten in 2013. Areas of focus are likely to include maintaining customer confidentiality and representations made by dark pool operators to its customers regarding the same, but in light of *Martoma*, there is a real likelihood of dark pools

being examined in connection with insider trading allegations. One thing is a given: As this area of regulation continues to evolve, participants in and operators of dark pools and ATS should not assume that trading in the dark shields them from the glare of the regulators’ spotlight.



1. Nina Mehta, “Dark Pool Growth Hurts Investors, NYSE, Nasdaq, Tell Senate,” Bloomberg (Dec. 18, 2012), available at <http://www.bloomberg.com/news/2012-12-18/dark-pool-expansion-hurts-investors-nyse-nasdaq-to-tell-senate.html>.

2. *United States v. Martoma*, No. 12-MAG-2985 (S.D.N.Y. Nov. 19, 2012); *Sec. & Exch. Comm’n v. CR Intrinsic Investors, Matthew Martoma, & Dr. Sidney Gilman*, No. 12-CIV-8466 (S.D.N.Y. Nov. 20, 2012), at ¶46.

3. *Sec. & Exch. Comm’n v. CR Intrinsic Investors, Matthew Martoma, & Dr. Sidney Gilman*, No. 12-CIV-8466 (S.D.N.Y. Nov. 20, 2012), at ¶46.

4. Order Approving Proposed Rule Change Relating to Publication of Certain Aggregate Daily Trading Volume Data, March 5, 2010, SEC. Rel. No. 34-61658 (Fed. Reg. Vol. 75, No. 48).

5. Regulation ATS, 17 C.F.R. §§202, 240, 242, 249 (2000).

6. Securities and Exchange Commission, Fact Sheet: Strengthening the Regulation of Dark Pools, Oct. 21, 2009, available at <http://www.sec.gov/news/press/2009/2009-223-fs.htm>.

7. *Id.*

8. Order Approving Proposed Rule Change Relating to Publication of Certain Aggregate Daily Trading Volume Data, March 5, 2010, SEC. Rel. No. 34-61658 (Fed. Reg. Vol. 75, No. 48).

9. See, e.g., Kit R. Roane, “How NYSE Plans to Use ‘Flash Crash’ to Reclaim Its Glory,” CNN, available at [http://money.cnn.com/2010/05/12/markets/NYSE\\_flash\\_crash.fortune/index.htm](http://money.cnn.com/2010/05/12/markets/NYSE_flash_crash.fortune/index.htm).

10. 17 C.F.R. §242.613 (Rule 613) (2012); see also “SEC Approves New Rule Requiring Consolidated Audit Trail to Monitor and Analyze Trading Activity,” available at <http://www.sec.gov/news/press/2012/2012-134.htm>.

11. Scott Patterson, “Vow of New Light for ‘Dark’ Trades,” *The Wall Street Journal*, Jan. 8, 2013, available at <http://online.wsj.com/article/SB10001424127887324391104578229610038363372.html>.

12. See also FINRA Enforcement Priorities for 2013, Jan. 11, 2013 (noting that ATS and the adequacy of disclosures provided to their customers and the manner in which the ATS operate will be a primary focus of FINRA’s 2013 examination program).

13. Rel. No. 34-65609 (Oct. 24, 2011).

14. Alternative Trading System Agrees to Settle Charges That It Failed to Disclose Trading by an Affiliate, SEC Press Rel., Oct. 24, 2011, available at <http://www.sec.gov/news/press/2011/2011-220.htm>.

15. Rel. No. 34-67969 (Oct. 3, 2012).

16. SEC Charges Boston-Based Dark Pool Operator for Failing to Protect Confidential Information, SEC Press Rel., Oct. 3, 2012, available at <http://www.sec.gov/news/press/2012/2012-204.htm>.