CFA Institute

POLICY BRIEF

DARK TRADING, MARKET QUALITY, AND GLOBAL POLICY DEVELOPMENTS

In the financial industry, dark pools are trading systems operated by banks and other firms that match trading interest (buy and sell orders) without pre-trade transparency. That is, the details of the orders entered into the system are not displayed (they are "dark"), although transactions are published afterwards. A large proportion of this trading volume comes from large financial institutions which want to trade away from public exchanges so as to minimise the "market impact" associated with their orders — that is, the risk of prices moving against them when their orders are revealed to the market.

POLICY DEVELOPMENTS

Several publications recently reported that New York Attorney General Eric Schneiderman has filed a fraud lawsuit against Barclays alleging that the bank gave high-frequency traders in its dark pool information that it did not share with other investors. Although regulators in the United States are considering dark pool regulation, their counterparts in Europe, Canada, and Australia already have taken action.

Regulatory Issues surrounding dark trading include:

- Potential impact on price discovery process when there is a substantial number of dark orders (in dark pools or otherwise) that may not be published
- Potential impact of fragmentation on information and liquidity searches
- Potential impact on market integrity arising from differences in access to markets and information.

CFA INSTITUTE ACTIONS

We have spoken out on issues related to dark pools. In addition to several meetings since 2010 with US SEC and European Commission staff on this issue, we have published several comment letters and papers including:

- CFA Institute report *Dark Pools, Internalization, and Equity Market Quality* (November 2012)
- Market Integrity Insights blog post "Dark Trading: Is it Hurting Market Quality?" (November 2012)
- Policy Perspectives Video: "Market Structure and the Impact of Dark Trading" (December 2012)
- Market Integrity Insights blog post "Views on MiFID II" (January 2014)
- CFA Institute Magazine article "CFA Institute and the MiFID II Policy Debate" (May/June 2014)

CFA INSTITUTE VIEWPOINT

Regulatory policy should be designed to support fair competition between exchange and off-exchange trading venues and protect investors who display quotes in the public markets. Specific recommendations include:

- Internalization of retail orders should be required to offer meaningful price improvement, thereby generating economically meaningful savings for retail investors, whilst upholding the incentives for investors to post displayed orders on public exchanges.
- Regulators should monitor the growth in dark trading and take appropriate measures if it grows excessively.
- Dark trading facilities should voluntarily improve reporting and disclosures around their operations to enable investors and regulators to make more informed decisions over their use.

Website: cfainstitute.org/ethics/integrity
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