

The FCA Peers Into Dark Pools

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On July 21, 2016, the Financial Conduct Authority (FCA) of the United Kingdom (UK) published a thematic review: UK equity market dark pools - Role, promotion and oversight in wholesale markets (TR 16/5) (Review): <http://www.fca.org.uk/your-fca/documents/thematic-reviews/tr16-05>.

Background

The FCA uses thematic reviews to assess a current or emerging risk relating to an issue or product across a number of firms within a sector or market. The Review examined (a) the promotion undertaken by dark pool operators, where the FCA sought to assess actual delivery versus promises and/or promotional materials proffered; and (b) the quality of the identification, management and disclosure of conflicts of interest by pool operators. In the Review, a 'dark pool' is defined as a trading venue with no pre-trade transparency in that all orders are hidden as to price and volume and are anonymous. This might include a broker crossing network (BCN), for example.

The findings and key messages in the Review were specifically identified as being pertinent to asset managers, who commonly use dark pools. Indeed, in developing its findings, it appears that the FCA met with a number of asset managers, as well as dark pool operators and aggregators, to understand better the relevant dynamics across the market and the responsibilities on each side of a trade.

A summary of the key findings of the Review are set out below.

Key findings

Asset managers

- Asset managers should be clear about their rationale for using or not using dark pools (why, how and when). It is very important that asset managers conduct adequate due diligence to thoroughly understand the operating model of a pool before commencing trading activity and be able to monitor ongoing activity and outcomes directly attributable to their use of a dark pool.

Asset managers and dark pool operators

- Asset managers and operators should remain alert as markets evolve. Infrastructure changes at the firm or industry level, the emergence of new participants and the shift of technological advantage among participants can give rise to significant new risks. Vigilance regarding a potential adverse impact on fair and orderly markets and best execution (where applicable) remains an important responsibility for all firms.
- Asset managers and operators should carefully consider the new MiFID II rules (that will apply from January 3, 2018) and the impact on existing and planned business models. Much financial regulation currently applicable in the UK derives from European Union (EU) legislation. This regulation will remain applicable until any changes are made, which will be a matter for the Government and Parliament of the UK. Firms must continue to abide by their obligations under UK law, including those derived from EU law and continue with implementation plans for legislation that is still to come into effect. The longer term impacts of the referendum decision to leave the EU on the overall regulatory framework for the UK will depend, in part, on the relationship that the UK seeks with the EU in the future.

Dark pool operators

- Operators need to provide clear detail as to the design and operation of a dark pool – particularly how it interacts with other activities on the operator's wider electronic trading platform. As no two pools are exactly alike, operators should ensure that disclosure or distributed materials on the services, key features and/or options offered by an internal crossing network are comprehensive, clear, fair and not misleading, and engage in discussions with users/clients to ensure that these materials are understood.

Operators should improve the monitoring of their pool(s) – in particular, operational integrity (accuracy of reference pricing, capacity, stability), best execution (where applicable), client preferences, and unwanted trading activity. The review and reporting on trading activity in a pool should reflect the relative sophistication and complexity of the features offered. The onus is on the operator to have adequate controls and oversight to ensure that all services, features and/or options made available to users consistently operate as designed and intended.

- Operators should do more to identify and manage conflicts of interest, including both client vs. client and operator vs. client. The mitigation steps taken such as membership controls, order queue prioritisation, order type restrictions, structural controls (e.g. speed bumps) and policies and procedures can be strengthened and independent assessments can be regularly refreshed. This is especially important as many operators offer access to a dark pool as a standard component of a wider brokerage agreement and as an integral component of an electronic trading platform.

Good and bad practices by operators of dark pools

The FCA also published a list of findings of what the FCA perceives to be good and bad practices by dark pool operators which is of use to asset managers in due diligence processes and in monitoring ongoing activity and outcomes. Some of the findings are listed below.

Good practices

- Detailed and focused due diligence on proposed activity in the pool by prospective clients.
- Onboarding discussions focused on clients' trading style, strategies, activity volumes and goals.
- Central storage for client preferences used as a 'golden source' for such data.
- Dynamic reassessment of routing logic based on market activity (e.g., price volatility, liquidity).
- Monitoring the latency of price feeds performed on a real-time basis.
- A clear process with defined thresholds for identifying and acting on stale prices.

- Analysing and grouping clients according to set criteria based on trading activity. Daily systematic checking of client preferences through a proactive push system.
- Establishing clearly defined metrics to monitor activity by group.
- Clear governance structures and appropriate terms of reference for each committee.
- Tight control over access to the dark pool platform data, with individuals logged on a 'need to know' list that was tightly regulated and frequently refreshed.
- Regular updates to the conflicts of interest policy and the register and recording of specific conflicts of interest that can arise with respect to its dark pool.
- Inclusion of specific scenarios related to algorithmic trading and the BCN in a conflicts of interest matrix.
- Tailored conflicts of interest training to include risks relating specifically to dark pools.
- Overarching infrastructure that specifically addressed dark pools, including best execution.
- Evidence of issues being identified and raised at the governance committee responsible for overseeing the pool by the business or by second or third lines of defence.
- A fully coordinated approach to control by the chief operating officer, compliance and technical support units.

Bad practices

- Generic due diligence that did not appropriately identify the risks posed by a client on an electronic trading platform.
- Stale assessments of client classifications and risk profiles with refresh not scheduled.
- Collection of preference information from clients in an inconsistent and uncontrolled manner.

Slow adjustment (or removal) of a speed bump originally introduced to equalise access to a pool after the need for it was resolved via other technical improvements.

- Allowing access by an in-house trading desk to its BCN via different infrastructure than clients, which gave it a potential latency advantage constrained only by management controls.
- Monitoring of pricing feeds on a post-trade basis only.
- No evidence of systematic monitoring of the client's activity in the pool.
- Use of pricing based on stale data (more than one second old), which then affected the smart order router.
- Lack of breach tracking or follow-up against breaches of undesirable activity thresholds.
- Use of outdated 'need to know' employee lists enabling staff who had left the relevant area of the firm continued access to dark pool information.
- System design that potentially allowed some traders to see resting orders and the aggregated order book.
- Allowing potentially hundreds of staff across the support infrastructure (i.e., a number well above any of its peer group of a similar scale) to have access to live trade data.
- Use of very generic high-level policies that were non-specific and difficult to apply to dark pools.
- Weak articulation of risks and conflicts of interest through the whole trading cycle.
- Ineffective internal management reports that relied on incorrect or outdated data.
- Weak escalation process for matters related to oversight with no evidence that the process was ever utilised.
- Inadequate definition and separation of responsibility between the first and second lines of defence for monitoring best execution or conflicts of interest related to dark pools.

Next steps

Next steps for asset managers that are dark pool users are:

- the FCA expects that asset managers that are dark pool users carefully will review the contents of the Review and its key messages, and reflect on their own operations and practices;
- ensure that business practices are fit for purpose and that these are supported by appropriate second line of defence controls. Users should ensure that they understand the attributes of individual pools and monitor their use to ensure that the expected benefits are obtained; and
- assess the risks and issues identified in the Review. Some additional obligations in MiFID II are intended to address a number of concerns specific to dark pools. Firms need to improve their current systems and controls and be ready for the implementation of future policy changes (including those associated with Brexit).

[Related Professionals](#)

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