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TITLE

EXAMINING THE ADEQUACY OF SOUTH AFRICAN OFF-EXCHANGE EQUITY SECURITIES TRADING REGULATION.

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DEDICATION.

To you; if you are reading this, at least my sleepless nights were not in vain

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CONTENTS

CHAPTER 1: INTRODUCTION 2

CHAPTER 2: OFF-EXCHANGE TRADING 7

(a) WHAT IS OFF-EXCHANGE TRADING? 7

(b) DARK POOLS AS A FORM OF OFF-EXCHANGE TRADING 9

(c) ORDER MATCHING AND PRICE DETERMINATION ON OFF-EXCHANGE PLATFORMS 13

(d) CATEGORIES OF OFF-EXCHANGE PLATFORMS 15

(e) ADVANTAGES PRESENTED BY OFF-EXCHANGE TRADING PLATFORMS 16

CHAPTER 3: POLICY REASONS FOR THE REGULATION OF OFF-EXCHANGE TRADING .20

(a) REGULATORY CONCERNS 22

(i) PRICE DISCOVERY 23

(ii) MARKET FRAGMENTATION 24

(iii) FAIR COMPETITION AND ACCESS 25

(iv) INVESTOR PROTECTION 27

CHAPTER 4: REGULATION OF OFF-EXCHANGE AND DARK POOL TRADING IN THE UNITED STATES AND THE UNITED KINGDOM 32

(a) UNITED KINGDOM 33

(b) UNITED STATES 37

(i) REGULATION ALTERNATIVE TRADING SYSTEMS (ATS) 38

(ii) REGULATION NATIONAL MARKET SYSTEM (NMS) 42

(c) ADDRESSSING THE POLICY CONCERNS 43

(i) PRICE DISCOVERY 43

(ii) MARKET FRAGMENTATION 43

(iii) FAIR COMPETITION AND ACCESS 44

(iv) INVESTOR PROTECTION 45

CHAPTER 5: SOUTH AFRICAN REGULATION OF OFF-EXCHANGE TRADING 46

(a) THE FINANCIAL MARKETS ACT 46

(b) THE JOHANNESBURG STOCK EXCHANGE EQUITIES RULES 48

CHAPTER 6: THE WAY FORWARD FOR SOUTH AFRICA 55

CHAPTER 1: INTRODUCTION

Worldwide, the way stocks were traded was previously relatively straight forward, investors would convey their intentions to a broker, who then routed these instructions to an exchange where the trade was executed with a matching order[1] which was part of the consolidated order book.[2] This way all players in the market had access to the same trading information pertaining to a given stock.[3] In the last decade however, there has been an increase in the available trading avenues to participants in the stock market worldwide, causing a considerable volume of stock trading to shift from the centralised market place to an environment of multiple trading avenues.[4][5] As a result, the same stocks are traded on the exchanges and on off-exchange private trading avenues. These developments left regulators perpetually behind the needs and operation of the market making it necessary to enact rules and legislation to govern and regulate these alternative avenues.[6]

The intention behind this paper is to examine off-exchange trading and the policy concerns behind it that could call for its regulation. The laws in other jurisdictions specifically the United States and the United Kingdom will be examined to understand how these concerns are addressed. Finally, the South African regulation of off-exchange trading avenues under the Financial Markets Act 19 of 2012[6] will be analysed to come to an understanding in comparison to other jurisdictions whether there are other platforms on which to trade listed shares other than on the exchange on which they are listed and if so, whether these off-exchange trades are regulated adequately (in line with the previously raised policy concerns). In the concluding chapter, recommendations are made as to the way forward for South Africa.

While there could be off-exchange trading of different securities, the focus in this instance is equity securities only. Off-exchange trading was previously referred to as 'upstairs trading,

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[1] PWC *An Objective Look at High Frequency Trading and Dark Pools* (2015) .

[2] An order book is an electronic list of buy and sell orders for a specific security organized by price level. The consolidated order book lists the number of shares being offered at each price point. It is an aggregation of orders. Degryse H, De Jong F and Kervel Vv 'The impact of dark trading and visible fragmentation on market quality' (2014) 19 *Review of Finance*

[3] Bierdermann Z 'Off-exchange Trading, Dark Pools and their Regulatory Dilemmas' (2015) 60 *Public Finance Quaterly* 78.

[4] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf accessed on 19-08-2016

[5] 0:42 UTC

[6] ORGANISATION JCSAIIR *Dark Pools, Dark Orders and Other Developments in Market Structure in Canada* CANADA, http://www.osc.gov.on.ca/documents/en/Securities-Category2/csa_20091002_23-404_consultationpaper.pdf accessed on 19-08-2016 11:24 UTC [6] Financial Markets Act of 2012.

this took place in an 'upstairs market' which can be in the broker dealer firm and not through an exchange which would be a regulated market.[7] With time, this form of trading has evolved to employ the use of technology to facilitate trading from a distance, entities also have formalities and structures in place to facilitate the trading of these securities.[8] One of such methods are through dark pools.

Although, this paper's emphasis is not largely on the intricacies of the way in which 'dark pools' function, breaking down the concept is necessary to illustrate how aspects of their operation becomes a legal issue and how trading in them differs from on an exchange. Dark pools in this instance have been selected for consideration to understand the regulation of private trading avenues and off-exchange trading of listed equity securities. Worth noting is the fact that a unique and homogenous definition to these private trading avenues is still yet to be found as they differ in types and design and in turn induce different definitions.[9]

With reference to the work of various authors, I intend to show that the policy concerns behind need for the regulation of formalised dark pools are substantially the same as those behind the need to regulate off-exchange trading of listed securities.[10] Several authors hold the view that when alternate trading systems function effectively, they can be a productive component of the market if they protect the investors property rights in information, solve the conflict of interest problems that arise when individual firms function both as dealers and brokers as well as innovate towards reducing the costs of transacting.[11] These policy issues both positive and negative will be examined in the context of the regulations enacted in other jurisdictions.

In the European Union, the Markets in Financial Instruments Directive (MiFID) [12] came into operation in November 2007. It provides a unified framework for securities which encompasses investment firms, Multilateral Trading Facilities, [13] regulated markets and

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[7] Gordon J and Davies P *Principles of Financial Regulation* Oxford University Press 2016) 150

[8] Garvey R, Huang T and Wu F *Why Do Traders Choose Dark Markets?* (2014)

[9] Gabriel J 'Fifty Shades of lights in Dark Pools new regulations' ^*Fifty Shades of lights in Dark Pools new regulations* 11-10-2016 15:13 UTC, available at http://uplaw.ch/fifty-shades-lights-dark-pools-new-regulations/, accessed on 11-10-2016 15:13 UTC

[10] Gabriel J 'Fifty Shades of lights in Dark Pools new regulations' ^*Fifty Shades of lights in Dark Pools new regulations* 11-10-2016 15:13 UTC, available at http://uplaw.ch/fifty-shades-lights-dark-pools-new-regulations/, accessed on 11-10-2016 15:13 UTC

[11] Macey JR and O'Hara M 'Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective.' (1999) 28 *The Journal of Legal Studies* 17

[12] Markets in Financial instuments Directive *European Union* 2004/39/EC

[13] A multilateral trading facility or 'MTF' is a multilateral system operated by an investment firm or market operator which brings together multiple third party buying and selling interests in financial instruments in

financial instruments.[14] It sought to capture the execution of trading of securities irrespective of the trading methods used to conclude these transactions. This directive removed the concentration rule which allowed orders to be routed to platforms other than the regulated market allowing these orders to be executed on other newly recognised platforms.[15] This resulted in the legal recognition of Multilateral Trading Facilities and systematic internalizers[16] allowing them to legally function side by side with the existing regulated markets.[17]

In the United States of America, the Securities and Exchange Commission in 2000 moved to recognise and regulate the different forms of off-exchange trading that were arising. This was done through Regulation ATS,[18] they took further steps in 2005 through Regulation NMS.[19] The regulation on alternative trading systems allowed these entities to choose whether to register as national securities exchanges under the Exchanges Act[19] or as broker dealers and comply with additional requirements dependent on nature of activities and trading volume with the aim being to integrate them into the national market system.[20]

In South Africa, the Financial Markets Act[22] defines an exchange as a person who constitutes, maintains and provides an infrastructure for bringing together buyers and sellers of securities, matching bids and offers for securities of multiple buyers and sellers and whereby a matched bid and offer for securities constitutes a transaction.[21] The Act makes it an offence to operate an exchange without being licensed to do so[22] and prohibits any person from acting as an authorised user unless authorised by a licensed exchange.[23] (Where an authorised user is

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accordance with non-discretionary rules. From: Article 4.15 Markets in Financial instuments Directive *European Union* 2004/39/EC

[14] Article 1 Markets in Financial instuments Directive *European Union* 2004/39/EC

[15] MiFID removed the concentration rule allowing listed securities to be traded on alternate avenues. Under this rule, orders could only be routed to regulated exchanges however with the operation of MiFID, parties are now free to choose the platform they want to route the orders to. From: Gentile M and Fioravanti SF 'The Impact of Market Fragmentation on European Stock Exchanges' (2011) 69 *CONSOB Working Paper*

[16] Systematic internalizers are also included in the definition of investment firms as they are an organised, frequent and systematic basis to deal on own account by the execution of client orders outside a regulated market or Multilateral Trading Facility. From: Gkantinis S 'Regualtion and Innovation: Comparing the U.S. and European Stock Trading Markets' (2006) 13 *Harvard Law School Student Scholarship Series* 35

[17] Annex 1 Markets in Financial instuments Directive *European Union* 2004/39/EC

[18] Regulation of Exchanges and Alternative Trading Systems Release Number 34-40760 17 CFR [19] Regulation NMS Stock Alternative Trading Systems Release Number 34-76474 17 CFR.

[19] United States of America Securities and Exchanges Act of 1934

[20] Securities and Exchange Commission 17 CFR Parts 201 Release No. 34-39884; File No s7-12-98

[22] Act 19 of 2012

[21] s1 Financial Markets Act of 2012

[22] s109(c) Financial Markets Act of 2012

[23] s4 Financial Markets Act of 2012

essentially a stock broker). Furthermore, a person may only carry out the business of buying or selling listed securities if that person;

(i) is an authorised user and complies with the relevant exchange rules,
(ii) effects such buying and selling through an authorised user in compliance with the relevant exchange rules,
(iii) is not an authorised user but a financial institution transacting as a principal or,
(iv) is a person subject to prescribed conditions if giving effect to a corporate finance transaction.[24]

If the activities of an entity fall within the above definition of an 'exchange', then it must be licenced as an exchange. If the activities do not fall within these criteria, then the entity need not register. I submit that this leaves a limited scope for carrying out off-exchange trades.

The above definition is the only one in South African law that would allow a party to legally constitute and maintain an infrastructure to bring together buyers and sellers of securities. Internalisation is the practice of order matching by investment firms which may also be referred to as in-house matching. When firms internalise, they execute client orders for their own account as well as agency crosses where client orders are matched against each other.[25] The Act[26] has no provisions that contemplate internalisation of trades which is one of the common forms of off-exchange trading and neither do the Equity rules of the Johannesburg Stock Exchange which state that all trades by members need to be matched by the trading system. They do however contemplate certain forms of book trades which could facilitate the matching of client orders.[27] The Act limits any possible scope for firms to internalise to the extent that the conduct contravenes Section 4 of the Act of the licensing provisions but does not limit the scope of permitted off-exchange trades that an exchange can permit its brokers to conduct.

Trading shares listed on a licensed exchange is subject to the provisions of the Act[28] and other relevant subordinate legislation including the rules of the exchange those shares are listed on however, in recent years, the regulator has focused on companies which maintained an infrastructure facilitating the trade of their own securities that were however not licensed as

[24] s24(a)-(d) Financial Markets Act of 2012
[25] Ferrarini G and Recine F 'The MiFID and internalisation' (2006)
[26] Financial Markets Act of 2012
[27] Rule 6.10.01 Johannesburg Stock Exchange Equities Rules
[28] Financial Markets Act of 2012

exchanges. These companies will now be required to register as exchanges or change their manner of operation to not fall within the definition of an exchange and therefore be required to register.[29]

The position of the Financial Services Board is that any off-exchange platform falling within the definition of an exchange based on its activities and not licensed as such is operating illegally.[30] On the basis of existing legislation and regulations I intend to examine the legal standing of off-exchange trading of listed equity securities in South Africa and whether there are off-market equity security trades that fall through the gaps in regulation by the Act or the exchange rules.

[29] s25 Financial Markets Act of 2012
[30] s109(c) Financial Markets Act of 2012

CHAPTER 2: OFF-EXCHANGE TRADING

(a) WHAT IS OFF-EXCHANGE TRADING?

The concept of off-exchange trading of listed equity securities is not a novel one. Previously, it was referred to as upstairs trading where traders made the deals in their offices before making the announcement as to the effect of the trade.[31] Upstairs trading would take place in an 'upstairs market' which can be in the broker – dealer firm and not through the trading floor of a stock exchange.[32] This way, brokers would work privately to find counter parties for the orders and to negotiate terms for transactions.[33] When this form of trading is done within the brokerage firm, the broker-dealer could act as an agent for both parties.[34] The trading of listed securities would then occur off the floor of the exchange which could essentially resulting in an 'over-the-counter' transaction. Some exchanges prohibit this manner of trading for securities listed on their platform.[35] What was previously referred to as upstairs trading has however evolved to employ the use of technology to facilitate 'trading from a distance' and these entities carrying out this form of trading have formalities and structures in place to facilitate the trading of these securities. These structures extend from the way orders are matched and routed to the way they are priced. It is therefore common worldwide for an individual stock to be traded in more than one market; this could occur if the same stock is traded in 'upstairs' and 'downstairs' markets. Downstairs markets being the trading floor or the network infrastructure provided by an exchange. [36] Orders on such a market would be visible to all market participants while in the former they would not be visible.

The focus in this paper on the trade of listed securities on platforms or through other mechanisms other than those provided by the exchange on which they are listed.

There are several avenues through which investors can conduct these off-exchange trades as a growing number of alternative trading systems have been introduced. These offer lower cost, off-exchange execution and in some cases, enable institutions to trade directly with one

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[31] Arin R and Easthope D 'Dark Pools: In the Eye of the Storm' ^*Dark Pools: In the Eye of the Storm* available at http://celent.com/reports/dark-pools-eye-storm, accessed on 03-05-2-16

[32] Gordon J and Davies P *Principles of Financial Regulation* Oxford University Press 2016) 150

[33] Garvey R, Huang T and Wu F *Why Do Traders Choose Dark Markets?* (2014)

[34] From:http://financial-dictionary.thefreedictionary.com/upstairs+market

[35] Foley S and Putnins JT *Regulatory Efforts to reduce dark reading in Canada and Australia: How have they worked?* (2014) *CFA institute*, https://www.cfainstitute.org/ethics/Documents/Trade-at%20Rule%20Report.pdf accessed on 12-11-2016 15:38 UTC

[36] Booth G, Lin J, T. M and Tse Y 'Trading and Pricing in Upstairs and Downstairs Stock Markets' (2002) 14 *Review of Financial Studies*

another.[37] One of these alternative trading systems that match sellers and buyers of securities away from the central exchanges are 'dark pools'. The other systems that can also be used to effect these trades are electronic communications networks, over-the-counter (OTC) transactions[38] and MTFs (Multilateral Trading Facilities).[41]

Off-exchange trading as a form of private trading venue grew in popularity however, still maintained an aura of mystery around it. Jaccard is of the view that, it is nothing but a recent and natural evolution of the market as it grew decentralised and over regulated as participants needed to fix the market inefficiencies when concluding a block trade.[39] While several other authors further the view that the initial reasoning behind these platforms was to protect an institutional trader from the adverse effect that would arise on an open market when his goal to either buy or sell large blocks of stock is revealed. This large volume on an open exchange will affect the price ahead of an intended trade which affects the strategy and overall intended position in the market. Hence, they lower the possible impact on the market and prevent the likelihood of parties trading ahead of the institutional trader's order and impacting the market.[40]

There are several factors that contributed to the growth of off-exchange platforms for stock trading, some of these are:

Shorter and Miller submit that when the markets are volatile, investors prefer to trade through an exchange. This is due to the certainty provided by the exchanges because they have displayed price discovery and are to a greater extent transparent. As the markets grew and got more stable, the demand for off-exchange platforms increased as there was barely any difference between trading on the exchanges and on the other platforms.[41]

They are also of the view that investors moved to off-exchange platforms to avoid the toxic liquidity that is provided by High Frequency Traders that had increased in the more developed

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[37] Clemons E and Weber B *Demand for off-exchange trading systems: Trading Preferences of Investors on the London Stock Exchange*. 15-05-1992 ed (1992)

[38] Darragh CK *Are you afraid of the Dark? High Frequency trading and the duties of dark pool operators* [41] A multilateral trading facility or MTF is a multilateral system operated by an investment firm or market operator which brings together multiple third party buying and selling interests in financial instruments in accordance with non-discretionary rules. Article 4(15) Markets in Financial Instruments Directive 2004/39/EC.

[39] Gabriel J 'Fifty Shades of lights in Dark Pools new regulations' ^*Fifty Shades of lights in Dark Pools new regulations* 11-10-2016 15:13 UTC, available at http://uplaw.ch/fifty-shades-lights-dark-pools-new-regulations/, accessed on 11-10-2016 15:13 UTC

[40] Meher J, Sagar J, Owyeung C and Patro V *Equity Trading in Dark Pools* (Babson College, 2013)

[41] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf accessed on 19-08-2016 17:13 UTC

world markets. A market exposed to high frequency traders runs a higher risk of a technological mishap therefore parties moved to platforms where they are protected from high frequency traders. The investors on these platforms have the autonomy to choose who to trade with. This is a choice they cannot make on an exchange due to the anonymity and open market nature under which exchanges function.[42] Furthermore, off-exchange platforms tend to charge lower fees than the exchanges. On these platforms, it is also possible to divide larger orders into smaller bits and therefore achieve faster execution while incurring lower fees per share traded. On an exchange comparatively, it would be costlier to conclude the trade in several small orders. [43]

(b) DARK POOLS AS A FORM OF OFF-EXCHANGE TRADING.

This paper's emphasis is not largely on the intricacies of the way in which dark pools function however breaking down the concept is necessary to illustrate how aspects of their operation becomes a legal issue. Dark pools were initially designed as a network to facilitate institutional block trades but have developed to include different order types that allow traders to remain anonymous during the trading process.[44] Although exchanges are also anonymous, the distinction appears that orders in these platforms are invisible to the people trading on the exchange and not these platforms. In this instance, they have been selected to illustrate the current regulation of private trading avenues and off-exchange trading of listed securities. This paper intends to show that the policy reasons behind the need for the regulation of formalised dark pools are largely the same as those behind the need to regulate off-exchange trading of listed equity securities.

Dark pools are an alternative trading system. This is an avenue for matching sellers and buyers of securities that is however not traditionally regulated as an exchange.[45] For purposes of this paper, a dark pool is a venue or mechanism containing non-displayed trading liquidity that is

[42] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf accessed on 19-08-2016 17:13 UTC

[43] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf accessed on 19-08-2016 17:13 UTC

[44] Meher J, Sagar J, Owyeung C and Patro V *Equity Trading in Dark Pools* (Babson College, 2013)

[45] Darragh CK *Are you afraid of the Dark? High Frequency trading and the duties of dark pool operators*

available for execution.[46] I submit the view that an institution's in-house pairing of a buyer and seller which occurs outside a public exchange is similar to how a dark pool operates.

The Securities and Exchange Commission (SEC)[47] defines dark pools as systems that allow participants to enter unpriced orders to buy and sell securities.[48] These orders are crossed (matched) at a specific time at a price derived from another market. A dark pool can also be described as an exchange that allows investors to purchase and sell securities without revealing their identities or displaying transactions to the public prior to the transaction[49] therefore, it does not provide quotes into the quote stream available to the public pre-trade[50]. This can be juxtaposed against conventional trading platforms which could be viewed as 'lit' due to the availability of consolidated stock price information that is publicly displayed on the consolidated tape.[51] Therefore, in broad terms, they are characterised by limited or no trade transparency, anonymity and derivative pricing (in most instances mid-quote pricing on quotes from a central exchange).[52]

Non-displayed liquidity is however not new to stock trading but the way it occurs has evolved rapidly with technology. Looking at the New York Stock Exchange for instance, the brokers had reserve orders sitting on their trading desks. Today with technology it is faster and easier to search for liquidity.[53]

In practice the term dark pool has been used to refer to a wide variety of either trading centres or services offered by alternative trading systems that do not publicly display quotes, electronic communications networks which allow for some or all of the quantity of an order to not be publicly displayed and broker dealers in the practice of systematic internalizing.[54] Therefore,

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[46] Banks E *Dark Pools; The Structure and Future of Off-Exchange Trading and Liquidity* Palgrave Macmillan 2010) 8

[47] The United States Security and Exchange Commission

[48] Klock M 'The SEC's New Regulation ATS: Placing the Myth of Market Fragmentation ahead of Economic Theory and Evidence' (1999) 753 *Florida Law Review*

[49] Darragh CK *Are you afraid of the Dark? High Frequency trading and the duties of dark pool operators*

[50] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf accessed on 19-08-2016 17:13 UTC

[51] Consolidated tape is a high speed electronic system that reports the latest price and volume data on sales of exchange listed stocks. Hazen TL 'Volatility and Market Inefficiency: A Commentary on the Effects of Options, Futures, and Risk Arbitrage on the Stock Market' (1987) 44 *Wash. & Lee L. Rev.*

[52] Buti S, Rindi B and Werner IM 'Diving into dark pools' (2011)

[53] Sachs G *Market Structure Overview* (2009) http://www.goldmansachs.com/our-thinking/archive/mktstructure.pdf accessed on 19-12-2016 01:53 UTC

[54] Sachs G *Market Structure Overview* (2009) http://www.goldmansachs.com/our-thinking/archive/mktstructure.pdf accessed on 19-12-2016 01:53 UTC

it can be held that the term encompasses all off-exchange platforms with emphasis on not publicly displaying the quotes.

When an investor places an order to buy or sell on an exchange typically, this quote is available to the public, in a dark pool however, an investor is only aware of potential counter parties only after the submission of the order. The trader may also opt to inform a limited number of other traders who are also clients of the dark pool of the availability of this order.[55] Under dark pool trading, the bid/ask quote is only made public to the consolidated tape after the completion of the transaction with the dark pool indicating that the trade was done but not revealing their identity.[56] In South Africa, this subsequent non-disclosure of the identity of investors would be subject to notification obligations in s56 and s122 of the Companies Act. [57] The consolidated tape is a high speed electronic system that reports the latest price and volume data on sales of exchange-listed stocks. The data reflected on the consolidated tape is generated by various market centres.[58] The information pertaining to the specific trade in a dark pool is undisclosed before and during trading but published to the consolidated tape which shows the last sale and trade data for the traded securities.[59] Exchanges on the other hand are both pre-trade and post trade transparent as they publicly disseminate market and trade information in real time.[60]

The distinction between upstairs trading and what would in effect be dark pool is that with a dark pool there are formalised structures in place to effect the trading of securities. These structures could facilitate the way orders are matched, routed and priced. In the jurisdiction of the Unites States, these structures have been recognised and regulated since 1998,[64] the United Kingdom on the other hand, until recently did not recognise these platforms under the regulatory structure[61]

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[55] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf accessed on 19-08-2016 17:13 UTC

[56] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf accessed on 19-08-2016 17:13 UTC

[57] Companies Act 71 of 2008

[58] https://www.sec.gov/fast-answers/answersconsolthtm.html

[59] Kerkhoff M 'Dipping our Toes into Dark Pools' ^*Dipping our Toes into Dark Pools* available at http://www.financialsense.com/contributors/matthew-kerkhoff/dipping-our-toes-into-dark-pools, accessed on 05-01-2016 14:53 UTC

[60] Dark pools, Internalization and Equity Market Quality. CFA Institute October 2012 Page 10 From: http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2012.n5.1 accessed on 20-04-2016 11:11 UTC [64] Regulation of Exchanges and Alternative Trading Systems Release Number 34-40760 17 CFR.

[61] Markets in Financial instuments Directive *European Union* 2004/39/EC

According to Shorter and Miller, generally, these platforms operate similarly to conventional exchanges regarding pricing and prioritization[62] of trades but do not disclose the market depth. The market depth would show the available (pending) unfilled orders for traded securities thus, a trader only becomes aware of the availability or lack thereof of potential counterparties after the submission of an order.[63] This non-disclosure goes towards the founding intention of this form of trading which was to conceal the execution of large traders with the aim of avoiding any price distorting effect. Although there is no pre-trade transparency in respect of trades in a dark pool, they are subject to post trade disclosure obligations. This makes it a requirement to make public (to the consolidated tape or national market system) the time, price and volume of each trade after it has been executed.[64] Bierdermann explains that this 'exemption' from pre-trade transparency limits the likelihood of information leakage, making them a preferred avenue for block traders.[65]

To a certain extent, due to their opaque nature they can be said to inhibit the free trade that open and transparent auction markets depend on to work, but are considered by institutional investors as a safer place to trade than the open regulated market.[66] With the growth of this trading avenue, traders began to use it not only for block trades but also for any other transactions in order to avoid the pre-trade transparency requirements which cannot be avoided on the open market.[67] Shorter and Miller explain that the functioning of dark pools has no direct impact on prices on the exchange as long as the trades are executed with a matching order; however, it may have an indirect effect.[68] On this note, the argument can be made that although dark pool trades will not affect price because they are invisible until disclosed, they remove the impact an open bid would have had on the market and therefore avoid the price movement that an open

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[62] Prioritization is the process to determine the sequence in which orders will be matched for execution. This is done based on time received and the bid or ask price.
http://www.businessdictionary.com/definition/prioritization.html accessed on 23-08-2016 12:17 UTC

[63] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf accessed on 19-08-2016 17:13 UTC

[64] Darragh CK *Are you afraid of the Dark? High Frequency trading and the duties of dark pool operators*

[65] Bierdermann Z 'Off-exchange Trading, Dark Pools and their Regulatory Dilemmas' (2015) 60 *Public Finance Quaterly* 78

[66] Clarke T 'High-frequency trading and dark pools: sharks never sleep' (2014) 8 *Law and Financial Markets Review*

[67] Bierdermann Z 'Off-exchange Trading, Dark Pools and their Regulatory Dilemmas' (2015) 60 *Public Finance Quaterly* 78

[68] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf accessed on 19-08-2016 17:13 UTC

bid would have caused. Participants may also be able to alter the value of a large trade in a dark pool by placing large buy or sell orders on the exchange whether they intend to execute these trades or not and affect the prices of the securities.[69]

The rise of high frequency trading motivated the rise of alternative trading avenues.[70] High frequency traders or HFTs can detect the availability of large orders due to the speed at which they transact. This puts investors transacting in large blocks of stock at a disadvantage because the HFTs can detect their orders, and transact against them resulting in the price paid or received for stocks being affected negatively. Dark pools reduce the likelihood of this happening because of the order book is not transparent. Although an advantage for institutional traders, it has to be weighed against the potential that it harms the price discovery process. This is more likely when a significant portion of that security's trade volume is dark pools. The lack of transparency could also erode the public investors' confidence in the public quote system.[71]

(c) ORDER MATCHING AND PRICE DETERMINATION ON OFF-EXCHANGE PLATFORMS.

Matching of orders is done when there are two equal but opposite orders to buy and sell a security.[72] On the traditional exchange, this would occur on the trading floor or with advances in technology, by computer algorithm. Off-exchange avenues like dark pools may however match orders on a continuous basis which would allow traders to trade at any time that the market is open. Comparatively, call markets only have trading open for a specified session. The traders all need to execute their trades within the session when the market is open.[73]

The orders may be matched in one of several ways depending on the way the chosen avenue operates. They may match orders on a continuous basis, during a call auction or notify

[69] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf accessed on 19-08-2016 17:13 UTC

[70] 'High frequency trading' is the use of powerful computers to transact large numbers of orders at very high speeds. A trader with faster execution speeds will be more profitable than those with slower speeds. As at 2009, it was estimated that more than 50 percent of trade volumes on the exchange were from high frequency trading orders. http://www.investopedia.com/terms/h/high-frequency-trading.asp

[71] An objective look at high frequency trading and dark pools www.pwc.com/us/InvestorResourceInstitute May 6 2015

[72] From: Farlex Financial Dictionary. 2012 Farlex, Inc.

[73] From:http://financetrain.com/call-market-vs-continuous-trading-market/

participants about potential matches[74]. When orders are matched continuously, they are executed as they are received and there is an available matching order during the trading day. Most stock exchanges match their orders on a continuous basis at any time that the market is open.[75] This gives traders and investors flexibility in choosing when to transact. With a call auction, the orders are collected and a predetermined time and venue is set for the auction to determine the price. The entire bid and ask orders are aggregated and transacted all at once. This leads to the determination of a single trading price based on the bid and ask orders that had been submitted and the trading volume is maximised.[76]

Primarily, these avenues arrive at stock prices in three ways; this could be done automatically by matching the midpoint between the best bid and offer price quoted on the exchange.[77] The best bid price is the highest price a buyer is willing to pay for stock and the best offer is the lowest price that a seller is willing to sell the stock. Matching in this manner could result in meaningful price improvement for both parties involved in the transaction.[78] When prices are arrived at in this manner, the transaction does not have much of an adverse effect on price discovery because the prices used are derived from the exchange.

Alternatively, they could use negotiated pricing where the buyer and the seller come to an agreement on the price at which to transact. This method has no market makers[83] or order pricing as the buyer and the seller actively work towards negotiating a price for the stock.[84] This is likely to have an adverse effect of price discovery because the agreed price is not a result of the market actors of demand and supply on the conventional stock market.

They may also use derived pricing where the price of the stock in question is determined based on the price movement of another stock. This is like the pricing of stock options.[79]

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[74] ORGANISATION JCSAIIR *Dark Pools, Dark Orders and Other Developments in Market Structure in Canada* CANADA, http://www.osc.gov.on.ca/documents/en/Securities-Category2/csa_20091002_23-404_consultationpaper.pdf accessed on 14-07-2016 19:26 UTC

[75] From:http://financetrain.com/call-market-vs-continuous-trading-market/

[76] From:http://financetrain.com/call-market-vs-continuous-trading-market/

[77] IOSCO" TCot *Issues Raised by Dark Liquidity* (2010) *OICV-IOSCO*, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD336.pdf accessed on 19-09-2016 10:45 UTC

[78] Foley S and Putnins JT *Regulatory Efforts to reduce dark reading in Canada and Australia: How have they worked?* (2014) *CFA institute*, https://www.cfainstitute.org/ethics/Documents/Trade-at%20Rule%20Report.pdf

[83] A market maker is a broker-dealer firm that assumes the risk of holding a certain number of shares of a particular security in order to facilitate the trading of that security. http://www.investopedia.com/terms/m/marketmaker.asp

[84] http://www.businessdictionary.com/definition/negotiated-market.html accessed on 19-08-2016 17:13 UTC

[79] Ye L 'Understanding the Impacts of Dark Pools on Price Discovery' (2016) *The Chinese University of Hong Kong, Shenzhen*

(d) CATEGORIES OF OFF-EXCHANGE PLATFORMS.

Off-exchange trading platforms can be placed into three broad categories with the distinction being drawn depending on the entity sponsoring it. This however is not a closed list.

Exchange-owned or agency broker: acting more like agents than principals, these operate with prices delivered from central exchanges[80] resulting in them lacking any element of price discovery.[81] Examples are: Liquidnet, Instinet and exchange owned (including those offered by BATS and the New York Stock Exchange).[82] The broker dealer founded Liquidnet intends to start operating on the South African capital markets at the time of this research. In 2010, the Johannesburg Stock Exchange took steps to allow for hidden order functionality and formed the dark pool 'Block X'. This functionality has however been scrapped and the JSE now aims to integrate opaque orders to be part of the central order book.[83] This is however only limited to volumes which would qualify a transaction as a block trade. These hidden orders can interact with all the liquidity available on the central exchange and the advantages that could come with it. They also heavily interact with the 'lit' market so as not to fragment liquidity. Therefore, having a minimal, if any, effect on market quality.[84]

Electronic Market Makers: These are provided by independent operators who act as principals for their own accounts. Unlike exchange owned or agency broker dark pools, these do not calculate prices from the National Best Bid and Offer (NBBO)[91] hence there is an element of price discovery.

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[80] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf accessed on 19-08-2016 17:13 UTC

[81] Price discovery is the determination of a security's price in the market place due to the interaction of the market forces of demand and supply. Factors such as supply, demand, participant's willingness to trade, past information and other external events affect these prices. From: Kara 'Shining a Light on Dark Pools' ^*Shining a Light on Dark Pools* available at http://sevenpillarsinstitute.org/case-studies/shining-light-dark-pools, accessed on 11-10-2016 14:39 UTC

[82] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf accessed on 19-08-2016 17:13 UTC

[83] An order book is an electronic list of buy and sell orders for a specific security or financial instrument, organized by price level. The order book lists the number of shares being bid or offered at each price point, or market depth. It also identifies the market participants behind the buy and sell orders, although some choose to remain anonymous. The order book is dynamic and constantly updated in real time throughout the day. From:http://www.investopedia.com/terms/o/order-book.asp#ixzz4WC1GDyPz

[84] http://financialmarketsjournal.co.za/oldsite/12thedition/printed%20articles/blockx.html

[91] NBBO is the highest bid and lowest offer price as quoted on the exchange.

Broker dealer owned: These are established by large brokers and dealers for clients and at times their own proprietary traders. With prices derived from order flow, these have an element of price discovery. Examples are: Morgan Stanley's MS Pool, Goldman Sachs' Sigma X, Credit Suisse's Crossfinder, and Citi's Citi Match.[85] Broker-dealer established dark pools may at times transact by use of internalization where the investor's transaction is executed by filling the order from available stock held by the broker as inventory. When the broker trades as principal, the stocks would be from inventory.[86]

(e) ADVANTAGES PRESENTED BY OFF-EXCHANGE TRADING PLATFORMS.

There are numerous potential positives that are the reason for the rising popularity of offexchange platforms such as dark pools and these are discussed below.

Their nature allows for the execution of large orders with minimal market impact arguably making trading cheaper.[87] This benefit extends to lower volume securities as well.[88] Notably, the crucial benefit sought of avoiding information leakage is not always achieved because there is very slight possibility of the buy and sell order sizes being the same size. The information leakage occurs when a trader submits a relatively small order and it is fully picked up. This indicates the likelihood that there is more of that stock still available to trade. Furthermore, traders could resort to practices like pinging[89] to reveal hidden order sizes. The difference in sizes is an avenue for leakage of information.[90]

An indication of interest or merely suspicion of interest by an institutional trader would adversely affect the market resulting in said trader either receiving less when selling shares or paying more when buying them. Anonymity would reduce the likelihood of price volatility

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[85] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf accessed on 19-08-2016 17:13 UTC

[86] Bierdermann Z 'Off-exchange Trading, Dark Pools and their Regulatory Dilemmas' (2015) 60 *Public Finance Quaterly* 78

[87] Gallo A 'Dark Pool Liquidity' (2013) 33 *Developments in Banking Law* 69

[88] An objective look at high frequency trading and dark pools www.pwc.com/us/InvestorResourceInstitute May 6 2015

[89] Pinging is when computerized firms also known as High Frequency traders try to detect what the bigger market participants are doing by repeatedly placing and cancelling thousands of stock orders to detect demand. The algorithm could be able to detect that a bigger participant is buying or selling a stock and act against them. Making the purchase or sale costlier for the other bigger participant which could be a mutual fund. From: http://www.wsj.com/articles/SB10001424052702303281504579219962494432336 accessed on 19-08-2016 17:09 UTC

[90] Bierdermann Z 'Off-exchange Trading, Dark Pools and their Regulatory Dilemmas' (2015) 60 *Public Finance Quaterly* 78

that would occur when there is a transparent central order book at the cost of concealing market depth. A transparent central order book would cause the market to react to the additional supply or demand caused by the large order. Some off–exchange platforms allow institutional traders to execute trades with minimal market impact.[91] The opaque nature of dark pool trading does not disclose the trading party or the trade volume until post trade and keeps most of the market in the dark until post trade disclosures. Hoffman P, concludes that this allows the large traders to get the prices they would have on an open market. Furthermore, dark orders leave less room for high frequency traders with predatory intentions (predatory trading induces and exploits other traders' need to reduce their positions)[92] from driving the price of a security either higher or lower depending on the information received and the rest of the market from acting against the interests of the block trader presenting a possible advantage for them.[93]

The nature of equity pricing in dark pools and off-exchange trading platforms could allow their investors to get a better price on listed securities.[94] I submit that this advantage pertains to both parties when they are trading large blocks of stock. In the trading of large stock orders, a dark pool may execute orders matching the mid-way point between the best bid and ask price which could result in a better price for both the buyer and seller. The best bid and offer prices will be derived from the market activity on a central exchange. Hence the institutional trader or dark pool participant benefits from a price created by the open market without exposure to the risk that the open market would present. On an open market, the order would be exposed to High Frequency Traders. As a result, the dark pool is only affecting price discovery to a lesser extent and the participants in the dark pool have objective criteria to use in the determination of prices.[95] Whether this results in a false market price will be addressed in the succeeding chapter.

Traders incur exchange fees when executing trades through a formal exchange. To fill a large order with minimal market impact, a broker may have to split the order into smaller bits and route through different exchanges or alternatively execute several smaller trades on the same

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[91] Darragh CK *Are you afraid of the Dark? High Frequency trading and the duties of dark pool operators*
[92] Brunnermeier MK and Lasse HP 'Predatory Trading' (2005) 60 *Journal of Finance* 1
[93] Hoffman P *Adverse Selection, Market Access and Inter-Market Competition* (2013) *European Central Bank*, https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1519.pdf?c1b3afb855b072385b088476c4bd83b9
[94] Harris L 'The Real Pros and Cons of Equity Trading in the 21st Century' ^*The Real Pros and Cons of Equity Trading in the 21st Century* available at https://www.marshall.usc.edu/faculty/insights/2011/real-pros-and-consequity-trading-21st-century, accessed on 14 August 27-11-2016 12:44 UTC
[95] Hoffman P *Adverse Selection, Market Access and Inter-Market Competition* (2013) *European Central Bank*, https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1519.pdf?c1b3afb855b072385b088476c4bd83b9 21-11-2016 12:34 UTC

exchange. The execution of several small trades will result in higher transaction costs. Comparatively, investors on off-exchange platforms like dark pools participants do not incur the same fees as those on exchanges, therefore even when an order is broken into several bits to increase the likelihood of execution there are no added transaction costs incurred. Furthermore, the routing to other brokers or splitting for the same exchange presents the risk of information leakage that could adversely affect price before all the orders are filled[96] Internalisation[97] is also likely in dark pools preventing the need for the order to be routed to another platform.

Unlike exchanges, dark pools give investors more control as to who they want to trade with. This gives traders more autonomy when choosing buyers or sellers.[98] Although dark pool trading is anonymous, when making a choice on which dark pool to trade in, investors cannot know who they are trading with but may ask to be made aware of whom the other participants in the pool are. This becomes necessary when disposing off large blocks of stock as it reduces the fear of the likelihood of a hostile takeover. It also keeps investors safe from predatory traders who would adversely affect price by limiting the parties with access to the stock. On a traditional exchange, any party would be able to purchase any stock available and the party selling would have no control over the identity of the party. The regulated market set up which gives access to all participants therefore makes it riskier to make strategic business decisions in the context of a listed company.

These off-exchange platforms present both possible advantages and disadvantages to the operation of the stock market. The disadvantages are addressed as policy concerns that make a case for their regulation.

With the increased use of alternative trading systems, there has been a need to bring their functioning up to date with the existing regulatory measures. The policy issues that arise and need to be considered mainly revolve around; price formation, market abuse and equal access

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[96] Hoffman P *Adverse Selection, Market Access and Inter-Market Competition* (2013) *European Central Bank*, https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1519.pdf?c1b3afb855b072385b088476c4bd83b9 accessed on 21-11-2016 12:34 UTC

[97] Internalization also referred to as internalized trading is when an investor's order is filled within the brokerage firm that the order was given to from stock that is held as inventory. Hence the order is not routed to be filled on any other platform http://www.investopedia.com/terms/i/internalization.asp

[98] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf accessed on 19-08-2016 17:13 UTC

to the liquidity held in dark pools and other off-exchange platforms. The concerns surrounding market abuse and equal access (fairness) give rise to the legal issues.

The speed of invention in trading of securities means in several cases the impact of these platforms can only be understood in retrospect by examining their effect on stock trading and the stock markets. Bierdermann writes that this has left regulators perpetually behind the needs of the market and called for a necessity to make changes to the existing regulations to protect investors and allow effective operation of the markets.[99] In the European, American, Canadian and Australian markets the regulators have taken steps and are still taking steps to align the regulations to the changing requirements of the market. In Europe, this was attempted through the review of the Markets in Financial Instruments Directive (MiFiD). In the USA, the SEC in 2010 reviewed the equity market structure. These changes to the regulation and the motivation behind them will be analysed in a later chapter of this paper.

This chapter lays the foundation and highlights the trading platforms that this paper focuses on. The next chapter will examine the policy concerns that arise with these off-exchange platforms.

[99] Bierdermann Z 'Off-exchange Trading, Dark Pools and their Regulatory Dilemmas' (2015) 60 *Public Finance Quaterly* 78

CHAPTER 3: POLICY REASONS FOR THE REGULATION OF OFF-EXCHANGE TRADING.

The preceding chapter introduced the concept of off-exchange trading of equity securities using dark pools as a consideration and looking at possible advantages that led to their use and growth. This chapter lays out the policy concerns behind the need for regulating the trade of securities and more specifically why, to the extent permitted, the trade of listed equity securities off-exchange should be regulated similar to exchange trades.

Securities regulation comprises the regulation of public issuers of securities, secondary markets and market intermediaries. The purpose of regulation is to address the gaps in information between the various market participants; issuers and investors, clients and intermediaries and between counterparties to transactions.[100] With the aim being to ensure smooth functioning of the markets to prevent any likely disruptions and foster public and investor confidence.[108]

The Financial Markets Act South Africa, requires exchanges to implement rules and adequate measures to ensure investor protection. An exchange is a self-regulating organisation and must enact and enforce its rules.[101] When entities participate in off-exchange trading they do not have the protection of the rules of an exchange unless the rules of said exchange extend to the regulation of off-market trades. An exception to this is when the off-exchange trading is facilitated by the central exchange as is the case with off-book trades as the Johannesburg Stock Exchange. In certain jurisdictions like the United States of America, Exchanges are classified as self-regulatory organizations[111] and entities that register as such have duties incurred above their primary functions. They also provide a wide range of services to the issuers and investors including regulatory oversight, internal rules of corporate governance, clearing and provision of liquidity.[102] Comparatively, entities functioning as alternative trading systems do not have the same duties and their short term private interests like lower transaction costs and better

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[100] Carvajal A and Elliot J *Strengths and Weaknesses in Securities Market Regulation: A Global Analysis* (2007) *IMF*, https://www.imf.org/external/pubs/ft/wp/2007/wp07259.pdf. Accessed on 28-10-2016 10:39 UTC. [108] Carvajal A and Elliot J *Strengths and Weaknesses in Securities Market Regulation: A Global Analysis* (2007) *IMF*, https://www.imf.org/external/pubs/ft/wp/2007/wp07259.pdf. Accessed on 28-10-2016 10:39 UTC.
[101] Board FM *Reviewing the Regulation of Financial Markets in South Africa* (2011) *Treasury Department of South Africa*, http://www.treasury.gov.za/public%20comments/FMB/FMB%20policy%20document.pdf [111] Macey JR and O'Hara M 'Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective.' (1999) 28 *The Journal of Legal Studies* 17.
[102] Macey JR and O'Hara M 'Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective.' (1999) 28 *The Journal of Legal Studies* 17.

prices for their clients are in competition with the overall markets' long term interests which call for efficient price discovery, investor confidence and protection.[103]

The markets have grown and evolved with other entities providing competition to the exchanges. Over-the-counter markets, alternative trading systems and even broker-dealer firms are able to fill customer orders completely in-house and provide the liquidity that exchanges used to have the monopoly of providing.[104] In the proceedings against Barclays Capital, it was held that off-exchange trading of listed stocks has increased significantly in recent years, and although it could provide many benefits to market participants it also highlights the necessity of transparency and a flow of information between the entities that operate these platforms and their clients.[105]

Alternative trading systems provide services like those of registered exchanges but are in most cases regulated as broker dealers. This creates disparities that could affect investors and the market at large. Furthermore, the activities carried out on these systems may not be adequately monitored under the regulatory regime making them prone to market manipulation and fraud.[106] Macey and O'Hara submit the view that when they function efficiently, they are a productive component of the market if they;

- protect their investors property rights in information,
- solve the conflict of interest problems that could arise when individual firms function both as dealers and brokers and,
- innovate towards reducing transaction costs.[107]

These possible benefits could be utilised if these platforms are regulated and monitored adequately.

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[103] Bierdermann Z 'Off-exchange Trading, Dark Pools and their Regulatory Dilemmas' (2015) 60 *Public Finance Quaterly* 78.

[104] Macey JR and O'Hara M 'Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective.' (1999) 28 *The Journal of Legal Studies* 17.

[105] *Barclays Capital Inc Order Instituting Administrative Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b) and 21C of the Securities Exchange Act.* 2016 1 (Securities and Exchange Commission)

[106] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf Accessed on 28-10-2016 10:39 UTC.

[107] Macey JR and O'Hara M 'Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective.' (1999) 28 *The Journal of Legal Studies* 17

In its concept release on equity market structure, the SEC articulates that, for financial markets to work optimally, investors need to be fully informed which requires a flow and access to information and the markets need to be free of fraud and manipulation.[108] Fraud and manipulation discourage investors and in turn impacts negatively on the public confidence in the markets. One of the factors that allowed the markets to grow to the extent they have is the widely-acknowledged benefit that they are normally free from fraud and manipulation.[119]

(a) REGULATORY CONCERNS.

The International Organisation of Securities Commissions (IOSCO) is the association of organisations that regulate the world's securities and futures markets.[109] According to IOSCO, there are three (3) main objectives for securities regulation, these are; protecting investors, ensuring that markets are fair, efficient and transparent and reducing systemic risk.[110] It is along these three broad principles that regulators in the different jurisdictions have set up the relevant legal framework. The technical committee of the IOSCO identified several issues surrounding the use of off-market platforms especially those with dark orders trading in the same securities as transparent markets.[111] These issues surround:

1. The impact on price discovery that dark orders could have on the quality of the market when there is a substantial amount of dark orders submitted to off-exchange platforms and these may or may not be published.

2. The impact of market fragmentation on information availability and liquidity on the markets.

3. The impact on the integrity of the markets due to possible differences in access to markets and information.[112]

It further outlines that the purpose of the regulation with regard to off-exchange platforms should be; to minimise the adverse impact of the increased use of off-exchange platforms like

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[108] Concept Release on Equity Market Structure 2010 34-61358 17 [119]
Concept Release on Equity Market Structure 2010 34-61358 17

[109] OICV-IOSCO 'International Organization of Securities Commissions' ^*International Organization of Securities Commissions* available at https://www.iosco.org/, accessed on 12/05/2016 15:40

[110] OICV-IOSCO *Objectives and Principles of Securities Regulation* (2010) *International Organization of Securities Commissions*, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf.

[111] IOSCO" TCot *Issues Raised by Dark Liquidity* (2010) *OICV-IOSCO*, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD336.pdf. accessed on 12/05/2016 15:40

[112] IOSCO" TCot *Issues Raised by Dark Liquidity* (2010) *OICV-IOSCO*, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD336.pdf. accessed on 12/05/2016 15:40

dark pools in transparent markets on price discovery process, to mitigate the effect of any potential fragmentation of information and liquidity, to ensure that regulators have enough information to monitor the use and running of these platforms and dark trade orders, to ensure investors have adequate information to enable them to understand the manner in which their orders are handled and executed and finally, to increase the monitoring of dark orders and dark pools to facilitate an appropriate response.[113]

This should all be aimed at the provision of mechanisms that reduce the risk of financial market failure, reduction of systemic risk, investor protection, ensuring that the markets are fair, efficient and transparent. Furthermore, securities market regulation should have mechanisms that reduce the risk of systemic failure. The regulations in place should be able to isolate the failure, if it arises, to the failing institutions and prevent the failure from affecting the system at large.[114] Inadequate regulation leaves the market prone to the risk of systemic failure if a market participant takes a risk that results in harm to the markets and other participants.

The regulatory debate revolved around issues of fair competition, access, market fragmentation, price discovery, investor protection and surveillance of market abuse. The next sections elaborate on these issues raised by the IOSCO.

(i) PRICE DISCOVERY

Price discovery is the process through which the market price for a security is established. This price is derived from the interaction between the demand and supply for a security which indicates participants' willingness to transact at a given price.[115] Although the ability to trade without publicly displaying orders is not new to the market, the IOSCO is of the view that offexchange platforms with dark orders could inhibit the price discovery process if orders that might have otherwise have been displayed become 'dark'.[116]

Off-exchange platforms that are 'dark' do not publish pre-trade data and they collectively account for a growing percentage of the daily trade in stocks. This raises the concern that the

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[113] IOSCO" TCot *Issues Raised by Dark Liquidity* (2010) *OICV-IOSCO*, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD336.pdf. accessed on 12/05/2016 15:40

[114] Board FM *Reviewing the Regulation of Financial Markets in South Africa* (2011) *Treasury Department of South Africa*, http://www.treasury.gov.za/public%20comments/FMB/FMB%20policy%20document.pdf.

[115] IOSCO" TCot *Issues Raised by Dark Liquidity* (2010) *OICV-IOSCO*, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD336.pdf accessed on 12/05/2016 15:40

[116] IOSCO" TCot *Issues Raised by Dark Liquidity* (2010) *OICV-IOSCO*, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD336.pdf accessed on 12/05/2016 15:40

stock exchanges may not reflect the actual market price based on the interaction of demand and supply and the available information to the public because these platforms impede the process of price discovery.[117][118] Several of these platforms derive their prices from the midpoint of the national best bid and offer prices as quoted on the exchange. Some authors hold the view that this is detrimental to the overall quality of the market.[119]

Anonymity for block traders enables them to get better value and in turn presents a problem for the rest of the market, the prices at which trades are executed may differ from those displayed on the public markets for the same security. This could result in traders who are not participants in the dark pool (retail traders) to receive prejudicial prices.[120] The loss of price discovery is worse when a significant volume of a given security is traded in the dark pools. When the trade is eventually reported, it could have an impact on the closing share price that a retail trader may not have had an opportunity to participate in making.[121] This could lead to the conclusion that this could either justify the prohibition of dark pools or the imposition of price discovery requirements on these dark pools.

(ii) MARKET FRAGMENTATION

The increase in trading avenues results in increased fragmentation of the market with regards to information and liquidity.[122] When shares are traded on a conventional centralised exchange, the liquidity and the available information pertaining to share price and availability is centralised. An investor or broker looking for bid information for a listed stock could look no further than the information as presented on the central exchange via the consolidated tape and market reports.

The fragmentation of the market could result in increased costs on market research before a party can make an informed decision on whether to transact in each stock.[133] After the execution

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[117] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf accessed on 19-08-2016

[118] :13 UTC

[119] Hatheway F, Kwan A and Zheng H *An Emperical Analysis of Market Segmentation on U.S. Equities Markets* (2013) SSRN,

[120] Klock M 'The SEC's New Regulation ATS: Placing the Myth of Market Fragmentation ahead of Economic Theory and Evidence' (1999) 753 *Florida Law Review*

[121] An Objective Look at High-Frequency Trading and Dark Pools. PWC (2015) From: http://www.pwc.com/us/en/pwc-investor-resource-institute/publications/assets/pwc-high-frequency-tradingdark-pools.pdf

[122] Kara 'Shining a Light on Dark Pools' ^*Shining a Light on Dark Pools* available at http://sevenpillarsinstitute.org/case-studies/shining-light-dark-pools, accessed on 11-10-2016 14:39 UTC

[133] Klock M 'The SEC's New Regulation ATS: Placing the Myth of Market Fragmentation ahead of Economic Theory and Evidence' (1999) 753 *Florida Law Review*

of a trade, information about that trade is reported on the consolidated tape. This data is available to the public. For off-exchange platforms such as dark pools, less information is conveyed. They merely indicate that the trade was executed off-exchange and not identify the specific platform on which the trade was executed furthermore, they do not disclose the bids that were made and not accepted. This hinders the public's ability to assess the various sources of liquidity in stock trading activity. [123] In general, unless a trader can send and receive indicators of interest, the only way they could know whether a dark platform has liquidity is to route an order to it. This could potentially lead to higher costs involved in finding liquidity and impact on market integrity with participants having to *ping* several platforms to assess liquidity.[124]

(iii) FAIR COMPETITION AND ACCESS.

One of the objectives of securities regulation as outlined by the IOSCO is to ensure that markets are fair, efficient and transparent. It is in this regard that it made the following statements;

- 'The fairness of the markets is closely linked to investor protection and, in particular, to the prevention of improper trading practices. Market structures should not unduly favour some market participants over others.
- Regulation should aim to ensure that investors are given fair access to market facilities and market or price information. It should also promote market practices that ensure fair treatment of orders and a price formation process that is reliable; and
- In an efficient market, the dissemination of relevant information is timely and widespread and is reflected in the price formation process.'[125]

Fair access is unlikely to be met if equal competitors are treated differently. Hence the aim of regulation should be to level the playing field between different market participants. This can be done by allowing the market forces to fairly influence the viability of Alternative Trading Systems.[126] Stock exchanges provide equal access to all market participants in a transparent

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[123] Strengthening the Regulation of Dark Pools. U.S Securities and Exchange Commission. From: https://www.sec.gov/news/press/2009/2009-223-fs.htm

[124] IOSCO" TCot *Issues Raised by Dark Liquidity* (2010) *OICV-IOSCO*, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD336.pdf.

[125] IOSCO" TCot *Issues Raised by Dark Liquidity* (2010) *OICV-IOSCO*, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD336.pdf

[126] Macey JR and O'Hara M 'Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective.' (1999) 28 *The Journal of Legal Studies* 17

manner, the same cannot be said for certain off-exchange platforms like dark pools especially those that are broker dealer sponsored. The issue of fair access could be partially solved if all investors had the same access to all platforms. Because although an exchange would still require full bid disclosure and a dark pool wouldn't, accessing the dark pool would not reveal market depth but allow investors who want to interact with the liquidity in the dark. Some platforms limit their accessibility to certain investors (in some cases only institutional investors) and this prevents other market participants from accessing liquidity that is only in the dark[127] and hindering them from accessing what could likely be a more profitable avenue to transact.[139] I submit that this only partially solves the problem because although brokers and asset managers can justify the costs of accessing a variety of platforms, it is unlikely that a small investor may be able to incur the costs involved. The existing market structures should not unduly favour some participants over others hence the regulation should ensure fair access by all investors to market facilities and information pertaining to the pricing of stocks. Some venues provide their clients with sponsored access to certain trading platforms however it is in the investor's best interests to provide them with equal and non-discriminatory access.[128]

Macey and O'Hara also believe transparency plays a key role in the fairness and efficiency of equity markets, it links dispersed markets reducing fragmentation, improving price discovery and competitiveness of the markets. However, there is difficulty determining what information should be transparent. Without any transparency markets could end up inefficient and unfair, on the other hand transparency could reduce the incentives for information gathering and penalize traders who are willing to either provide or seek liquidity.[129]

Before a trade is executed on a stock exchange, a quotation is publicly displayed for other investors and market participants to see. On off-exchange platforms such as dark pools which use indicators of interest, a participant's indicator is only conveyed to selected market participants.[130] The 'SEC' is of the view that these indicators contain valuable trading information and are deemed actionable when explicitly or implicitly inform the recipient about

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[127] Shining a light in Dark Pools From: http://sevenpillarsinstitute.org/case-studies/shining-light-dark-pools 39 [139] Arin R and Easthope D 'Dark Pools: In the Eye of the Storm' ^*Dark Pools: In the Eye of the Storm* available at http://celent.com/reports/dark-pools-eye-storm, accessed on 03-05-2-16

[128] IOSCO" TCot *Issues Raised by Dark Liquidity* (2010) *OICV-IOSCO,* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD336.pdf

[129] Macey JR and O'Hara M 'Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective.' (1999) 28 *The Journal of Legal Studies* 17

[130] IOSCO" TCot *Issues Raised by Dark Liquidity* (2010) *OICV-IOSCO,* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD336.pdf

other available offers. This conveyance of indicators to only certain participants could create a two-tiered market in which the participants that did not get this information are disadvantaged and the public does not have fair access to information about the best available prices and sizes for stocks that other certain select participants may have access to.[131]

Klock, M submits that, the need to make block trades hidden from the public leads to an increase in the possibility of the trade not being executed due to the limited liquidity that the investor is interacting with.[132] As the execution of a trade depends on the matching of orders, in an anonymous environment, finding an equilibrium point between demand and supply is more complex and therefore the matching of orders as well. Off-exchange platforms like dark pools do not provide a guarantee that the mandate to trade will be implemented, because for an order to be matched there needs to be an order on the opposite side of the market, absent which there will be no match and therefore the trade will not be executed. The limited liquidity that the investor interacts with on these off-exchange platforms increases the likelihood of a failure to execute the trade. This risk is minimised on a public exchange as any one participant in the market has access to the order information and therefore acts towards increasing the available liquidity.[133] Investor access to the best markets is an objective of the market regulators aimed at giving traders the ability to obtain best execution by transacting their order at the prevailing price regardless of platform they chose to trade on.[134]

(iv) INVESTOR PROTECTION.

Exchanges provide the important function of monitoring and thus protect the investors from some aspects of share price manipulation and insider trading. [135] When transacting on an exchange, the identity of the counter party is unknown and the parties to the transaction do not

[131] Commission SaE 'Strengthening the Regulation of Dark Pools' ^*Strengthening the Regulation of Dark Pools* available at https://www.sec.gov/news/press/2009/2009-223-fs.htm, accessed on 31/10/2016 13:47

[132] Klock M 'The SEC's New Regulation ATS: Placing the Myth of Market Fragmentation ahead of Economic Theory and Evidence' (1999) 753 *Florida Law Review*

[133] Klock M 'The SEC's New Regulation ATS: Placing the Myth of Market Fragmentation ahead of Economic Theory and Evidence' (1999) 753 *Florida Law Review*

[134] IOSCO" TCot *Issues Raised by Dark Liquidity* (2010) *OICV-IOSCO*, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD336.pdf accessed on 12/05/2016 15:40

[135] Macey JR and O'Hara M 'Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective.' (1999) 28 *The Journal of Legal Studies* 17

have a contractual relationship but rather one with their broker. In the event of a conflict, the exchange can remedy this based on the existing laws and its own rules.[136]

Some off-exchange platforms function under limited pre-trade transparency. This raises questions as to whether they could be an avenue for unfair market practices. In the United States, the regulators observed that dark pools could be used to facilitate potentially improper trades. This could arise as the traders have access to confidential information regarding the client's trades.[137]

In 2011, the Securities and Exchange Commission brought an enforcement action against an operator for falsely advertising that no proprietary trading took place within its pool. That pool gave its proprietary trading desk an unfair informational advantage over other subscribers which it used to front run the subscribers' orders with the full knowledge that this was improper.[138] Barclays is the operator of an Alternative Trading System registered as Barclays LX. It has been in operation since 1998 pursuant to the adoption of Regulation ATS. The system operates as a 'dark pool' that accepts matches and executes orders from clients to buy and sell stocks under the National Market System (NMS). As of May 2014, it was the second largest Alternative Trading System dealing in stock on the National Market System.[139] Barclays was found to be in breach of federal securities laws by making materially misleading statements regarding the way their dark pool was operating. It was found to have allegedly made misrepresentations to its clients regarding the manner in which its dark pool functioned and failed to protect the confidential information of its clients by secretly offering high frequency traders access to the client's order feeds and special order types giving them an advantage over subscribers.[140] This in some instances allowed the high frequency traders to front run the clients offers which was detrimental to the prices received in some cases by the clients.

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[136] Macey JR and O'Hara M 'Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective.' (1999) 28 *The Journal of Legal Studies* 17

[137] Sullivan NE and Russello GJ "Dark Pool' Trading is Not Shielded From Regulatory Spotlight' (2013) 17 *New York Law Journal*

[138] Aguilar CLA *Shedding Light on Dark Pools* (2015) U.S. Securities and Exchange Commission,

[139] *Barclays Capital Inc Order Instituting Administrative Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b) and 21C of the Securities Exchange Act.* 2016 1 (Securities and Exchange Commission)

[140] *Barclays Capital Inc Order Instituting Administrative Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b) and 21C of the Securities Exchange Act.* 2016 1 (Securities and Exchange Commission)

The way off-exchange platforms function creates a need for liquidity, this in turn has intensified certain conflicts of interest between the operators and the subscribers' due to their highly-veiled nature.[141] A broker with an order from an investor could practice front running where they trade for themselves ahead of filling the client's order to benefit from the price quoted by the client.[142] They may also trade on the opposite side of a strong buy recommendation to their clients to benefit from the eventual price movement caused by the increase in demand. Proprietary traders could also abuse it by trading against pool clients. This is a risk in broker-dealer owned dark pools and electronic market makers who in some cases may act as a principle for the trades they execute.[143] The broker operators are able to benefit from information on orders flowing into their platforms.[144] In instances when the dark pool is run by a brokerdealer, during the process of internalization the broker may be able to make a profit on the stock held as inventory.[145]

When these alternative trading systems act exclusively for their clients, they eliminate the conflict of interest problem that arises with the internalization by broker-dealers as they only offer a trade execution service.[146] The likelihood of a profit motive may affect the ability of the broker to fill the order at the best possible price which would be in the best interests of the investor. The broker may then be able to make a secret profit which would be a conflict of interest and against the common-law principle of agency.[147] Dealers have an incentive to sell the weak stock that they have accumulated in inventory as brokers and to purchase the strong stocks from their clients. Regulation attempts to address this conflict by prohibiting

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[141] Aguilar CLA *Shedding Light on Dark Pools* (2015) U.S. Securities and Exchange Commission,

[142] Front running is the questionably ethical practice by which a broker trades for his own benefit based on advance knowledge of a client's pending orders. This is aimed at making a profit or avoiding a loss when the client's order is eventually filled. http://www.investopedia.com/terms/f/frontrunning.asp accessed on 12/12/2016 15:40 UTC

[143] Pros and Cons of Dark Pools of Liquidity | Investopedia http://www.investopedia.com/articles/investing/060915/pros-and-cons-dark-pools-liquidity.asp#ixzz4Ct829DcD accessed on 12/05/2016 15:40 UTC.

[144] Arin R and Easthope D 'Dark Pools: In the Eye of the Storm' ^*Dark Pools: In the Eye of the Storm* available at http://celent.com/reports/dark-pools-eye-storm, accessed on 03-05-2-16 12:36 UTC

[145] Bierdermann Z 'Off-exchange Trading, Dark Pools and their Regulatory Dilemmas' (2015) 60 *Public Finance Quaterly* 78

[146] Macey JR and O'Hara M 'Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective.' (1999) 28 *The Journal of Legal Studies* 17

[147] Common Law requires that an agent should not make any profit or acquire any benefit in the course and in the matter of his agency without the knowledge and consent of his principal. In ITC 1972 (67 SATC 236) [160]Macey JR and O'Hara M 'Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective.' (1999) 28 *The Journal of Legal Studies* 17

brokerdealers from front-running (trading ahead) a client's order or maintaining accounts that belong to employees of other broker dealers.[160]

Financial institutions that make large stock purchases have long been accustomed to breaking up their orders to avoid tipping off the market. However, because buy and sell orders are bounced around so widely, algorithms can detect what their intentions are hence they developed craftier and high-tech measures to get around this.[148] Left unchecked, the orders placed by investors in dark pools are vulnerable to predatory trading practices. Predatory trading practices can include slow market arbitrage where high frequency traders seek to profit off the minute price differences of stocks on different exchanges.[149] High frequency traders may place small orders in dark pools to detect any large hidden orders. This practice is known as pinging.[150] High frequency traders are then able to make an opposite trade by front running the available orders and hence making a profit at the expense of the institutional trader in the dark pool when the shares are sold back to the investor.[151] Since most of these platforms use prices displayed on regulated markets as a reference price, it is technically possible to manipulate execution prices in dark pools by artificially affecting the prices on the exchanges. Furthermore, high frequency traders benefit from the knowledge of price movements on the regulated markets before placing their orders in dark pools.[152]

As a general principle, participants in a dark pool have no guarantee of getting the best price for their securities as there is no guarantee for execution at the best price. Depending on the client's instructions, the broker may have the autonomy to route the order via an exchange (or any other avenue) of their choosing, when making this decision the broker may prioritize a higher probability of execution over the best price for execution.[153] Furthermore, with the practice of internalization the interests of the broker may be to transact on the stocks held as

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[148] Bunge J 'A Suspect Emerges in Stock-Trade Hiccups: Regulation NMS' (2014) *Wall Street Journal*

[149] Easley D, López de Prado MM and O'Hara M 'Flow Toxicity and Liquidity in a High-frequency World' (2012) 25 *The Review of Financial Studies*

[150] Pinging refers to the practice of entering smaller marketable orders with the aim of learning about the availability of large hidden orders in dark pools or exchanges. The execution of the smaller order could reveal the availability of a large hidden order. http://www.investopedia.com/articles/active-trading/042414/youd-betterknow-your-highfrequency-trading-terminology.asp

[151] Internalization also referred to as internalized trading is when an investor's order is filled within the brokerage firm that the order was given to. http://www.investopedia.com/terms/i/internalization.asp

[152] Arin R and Easthope D 'Dark Pools: In the Eye of the Storm' ^*Dark Pools: In the Eye of the Storm* available at http://celent.com/reports/dark-pools-eye-storm, accessed on 03-05-2-16 13:45 UTC.

[153] Bierdermann Z 'Off-exchange Trading, Dark Pools and their Regulatory Dilemmas' (2015) 60 *Public Finance Quaterly* 78

inventory which would be advantageous to them but not necessarily always the client and unless the regulatory scheme provides for price improvement[154] as is the case in the United states, it would not be a priority for the broker to execute the trade at the best price for the client. [155][156]

The different regulation of exchanges and off exchange platforms could provide an opportunity for regulatory arbitrage where market participants choose avenues based on which regulations in which avenue would provide them with a trading advantage. Uniformity of rules and regulations reduces this possibility.[157]

The next chapter will examine how these policy concerns have been addressed in the United States of America and the European Union.

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[154] Arin R and Easthope D 'Dark Pools: In the Eye of the Storm' ^*Dark Pools: In the Eye of the Storm* available at http://celent.com/reports/dark-pools-eye-storm, accessed on 03-05-2-16 13.45 UTC.

[155] Picardo E 'An Introduction to Dark Pools' ^*An Introduction to Dark Pools* 02/09/2014, available at http://194.145.208.139/ANTI/ADMXI/documentation/ALGORITHM_DOCUMENTATION/FEMTO-BLACKPOOL/DARKPOOLS/INVESTOPEDIA/2014_Investopedia_An_Introduction_to_dark_pools.pdf, accessed on

[156] /03/2017

[157] Easley D, López de Prado MM and O'Hara M 'Flow Toxicity and Liquidity in a High-frequency World' (2012) 25 *The Review of Financial Studies*

CHAPTER 4: REGULATION OF OFF-EXCHANGE AND DARK POOL TRADING IN THE UNITED STATES AND THE UNITED KINGDOM.

The previous chapter to this paper examined the policy concerns that arise with the increased use of alternative avenues carrying out off-exchange trading of equity securities. It is these policy concerns that the legislators in the United States of America and the European Union aimed to address. This was done through the Regulation Alternative Trading Systems (Regulation ATS) and Regulation National Market System (Regulation NMS) in the United States and the Markets in Financial Instruments Directive 2004/39/EC in the European Union.

In November 2007, the Markets in Financial Instruments Directive 2004/39/EC came into force in the European Union,[158] in the United states the Securities and Exchange Commission had in 2000 moved to regulate forms of off exchange trading such as dark pools through Regulation ATS[159] and in 2005 went further with Regulation NMS (NMS for national market system).[160] These were both regulatory changes that were necessary to catch up with the on goings in the financial markets after gaps were revealed in the securities regulations and more specific to the content of this paper the need to regulate the several other avenues of securities trading whose use was on the rise. Notably, in Europe, dark trading had always been possible but only as reserve orders or non-displayed orders offered by broker pools or public trading avenues.[161] This is similar to the present position in South Africa.

The objective of the Markets in Financial Instruments Directive (MiFID) is to foster a fair, competitive, transparent, efficient and integrated European financial market that offers high investor protection and allows for the creation of new markets and services.[162] Both MiFID and regulation ATS intended to create a fair, level playing field for the different types of trading platforms.[163] One author however notes, a distinction between the two regulatory efforts is that 'dark pools' are not explicitly captured by MiFID even though they account for a substantial amount of trading volume, while in the United States, they are considered alternative trading

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[158] Markets in Financial Instruments Directive 2004/39/EC.
[159] Regulation Alternative Trading Systems 1998 242 .
[160] Regulation NMS Stock Alternative Trading Systems Release Number 34-76474 17 CFR.
[161] Bierdermann Z 'Off-exchange Trading, Dark Pools and their Regulatory Dilemmas' (2015) 60 *Public Finance Quaterly* 78.
[162] Markets in Financial Instruments Directive 2004/39/EC.
[163] Degryse H 'Competition between Financial Markets in Europe: What can be expected from MiFID?' (2009) 23 *Financial Markets and Portfolio Management* 93.

systems and are registered as broker-dealers that do not display public quotes as long as they are below the legally set threshold.[164]

The European commission proposed amendments to MiFID resulting in MiFID II that will take effect 3 January 2018. The new directive and will go a long way towards changing the landscape of off-exchange trading among other aspects of the financial markets in Europe. However, as it is not yet in force, only a brief examination will be done to compare the current the laws to the proposed ones. Furthermore, the effect of Britain's exit from the European Union on financial regulation remains to be seen, therefore this paper examines the existing laws as they exist and are applied.

(a) UNITED KINGDOM

MiFID was a key development in the European regulatory atmosphere replacing the Investment Services Directive (93/22/EEC) and introducing concepts that had previously not existed within the regulatory framework like multilateral trading facilities and systematic internalizers.[165] The United Kingdom transposed this directive by way of the Financial Services and Markets Act 2000.[166] The Financial Conduct Authority is tasked with the regulation of the trade of securities under this act. This is however subject to the European law which provides a unified framework for securities which encompasses investment firms, Multilateral Trading Facilities (MTFs)[167], regulated markets (conventional exchanges) and financial instruments.[180]

MiFID applies to investment firms and regulated markets. It defines investment firms as any person whose regular occupation or business or the provision of investment services to third parties and/or the performance of one or more investment activities on a professional basis. Systematic internalizers are also included in the definition of investment firms as they are an organised, frequent and systematic basis to deal on own account by the execution of client orders outside a regulated market or Multilateral Trading Facility.[168] Therefore, the directive

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[164] Gkantinis S 'Regualtion and Innovation: Comparing the U.S. and European Stock Trading Markets' (2006) 13 *Harvard Law School Student Scholarship Series* 35.

[165] Transposition of the Markets in Financial Instruments Directive II March 2015 From: http://www.gov.uk/government/publications.

[166] Financial Services and Markets Act 2000 United Kingdom.

[167] A multilateral trading facility or MTF is a multilateral system operated by an investment firm or market operator which brings together multiple third party buying and selling interests in financial instruments in accordance with non-discretionary rules in a way that results in a contract in accordance with the provisions of Title II. Article 4(15) Markets in Financial Instruments Directive 2004/39/EC. [180] Markets in Financial Instruments Directive 2004/39/EC.

[168] Gkantinis S 'Regualtion and Innovation: Comparing the U.S. and European Stock Trading Markets' (2006) 13 *Harvard Law School Student Scholarship Series* 35.

sought to capture the execution of trading in securities irrespective of the trading methods used to conclude these transactions. It has a list of activities is classifies as investment services. These are; The reception and transmission of orders in relation to one or more financial instruments, execution or orders on behalf of clients, dealing in own account, portfolio management, investment advice, underwriting financial instruments, placement of financial orders and the operation of multilateral trading facilities.[169]

A key development under MiFID was the removal of the concentration rule.[170] Under this rule, firms could only route orders to regulated markets. The removal of this restriction opened the market to other participants because orders for listed securities could then be routed to regulated markets, multilateral trading facilities or even systematic internalizers.[171] This allowed the alternative avenues to function and trade in the same securities as the regulated markets giving them legal recognition for regulatory purposes. The main service in focus here is the operation of multilateral trading facilities as they can execute trades of public securities off the regulated exchange. A party with the intention of facilitating off exchange trading has the option of registering as a multilateral trading facility but they do not have to.[172]

In Europe, Dark pools may be classified in one of two categories; Dark pools operated by broker-dealers or investment banks, also called crossing networks and dark pools operated as Multilateral Trading Facilities. A crossing network is an alternative trading system that matches buy and sell orders electronically for execution without first routing the order to an exchange or other displayed market.[173] They can be seen as merely the automation of overthe-counter trades that have always been carried out to facilitate the execution of client's orders.[174] A multilateral trading facility or MTF is a multilateral system operated by an investment firm or market operator which brings together multiple third party buying and selling interests in

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[169] Annex 1 Markets in Financial Instruments Directive 2004/39/EC.

[170] Gkantinis S 'Regualtion and Innovation: Comparing the U.S. and European Stock Trading Markets' (2006) 13 *Harvard Law School Student Scholarship Series* 35.

[171] Giovanni P 'MiFID, Reg NMS and competition across trading venues in Europe and the USA' (2010) 18 *Journal of Financial Regulation and Compliance* 264.

[172] Moloney N and Ferrarini G 'Reshaping order execution in the EU and the role of interest groups under MiFID II' (2012) 13 *European Business Organization Law Review* 560.

[173] From: http://lexicon.ft.com/Term?term=crossing-networks. accessed on 12/05/2017 13:56 UTC

[174] Gkantinis S 'Regualtion and Innovation: Comparing the U.S. and European Stock Trading Markets' (2006) 13 *Harvard Law School Student Scholarship Series* 35.

financial instruments in accordance with non-discretionary rules.[175] They however do not offer listing or clearing of securities and are in essence an alternative trading system to exchanges.

Crossing networks do not have to comply with MiFID pre trade transparency requirements and with other rules imposed on regulated markets (conventional exchanges) and Multilateral Trading Facilities such as the obligation to treat investors equally, to provide fair access to the trading platform and the market surveillance, and to operate a non-discretionary system for the execution of orders.[176] These crossing networks exist under the scope of off-exchange trading and under the directive there is no requirement for pre trade transparency for such trades.[177] Those operated as MTFs however have to comply but they do benefit from some pre trade transparency waivers.[191] The pre trade reporting obligations are however applied across the board for all public shares traded outside a regulated market.

The directive further classifies the operation of an MTF as an investment service therefore placing an obligation on member states to ensure that their market participants comply with the provisions of the directive relevant to off-exchange trading.[178] A party intending to operate a multilateral trading facility would have to register an investment firm.[179] As an organisational requirement, these firms are required to establish, maintain and, operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest from adversely affecting the rights of their clients.[180] In instances where a conflict of interest still exists in spite of the measures the firm has in place, they have an obligation to disclose the exact nature of this likely conflict to their clients before undertaking any business on their behalf.[181]

This directive also requires the firms to have an objective and non-discretionary criteria and rules for the efficient execution of orders,[182] they are also obliged to have transparent rules for the criteria determining the financial instruments that can be traded on their platform under

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[175] Article 4(15) Markets in Financial Instruments Directive 2004/39/EC.
[176] Article 14(1) Markets in Financial Instruments Directive 2004/39/EC.
[177] Objectives and Principles of Securities Regulation International Organization of Securities Commissions June 2010 From: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf. accessed on 12/05/2016 15:40 [191] Article 29(2) Markets in Financial Instruments Directive 2004/39/EC.
[178] Article 4 Markets in Financial Instruments Directive 2004/39/EC.
[179] Article 4(1) Markets in Financial Instruments Directive 2004/39/EC.
[180] Article 13(3) Markets in Financial Instruments Directive 2004/39/EC.
[181] Article 18(2) Markets in Financial Instruments Directive 2004/39/EC.
[182] Article 14(1) Markets in Financial Instruments Directive 2004/39/EC.

their systems.[183] Transparent rules and objective criteria are required governing access to the facility. I submit that this was aimed towards promoting fairness in the markets.

The directive further places an obligation on the firms operating MTFs to uphold the integrity of the markets to prevent market abuse, insider trading and to timely report trades executed on their platform.[198] It also places a requirement for pre-trade transparency requiring platforms to publish (on the platform on which these securities are registered) in real time the current orders and quotes relating to shares.[184] There is however, an exception to this for systems that do not determine prices on their own but generate them from another system (this can be the central exchange) or for when the transactions are large in scale.[185] It is this exception that allows for the creation of dark liquidity in the European Markets and hence dark pools.

In October 2011, the European Commission released a proposal to amend and extend MiFID which is referred to as MiFID II. This will contain measures to regulate dark trading in Europe. This was approached from the perspective of the regulation of broker crossing networks which under MiFID are outside the regulatory scope and did not have to comply with the same rules as MTFs. The amended directive also modifies the waivers for pre-trade transparency.[186]

The commission proposed a new category Organised Trading Facilities(OTFs) which was mainly to encompass the OTC derivative market and equities. OTFs would encompass any type of electronic trading platform that matches orders multilaterally amongst the users of the platform but where there is some discretion over the way in which orders are executed. This category was created to ensure that all systemized trading is captured under the new proposed MiFID framework to minimise regulatory arbitrage. This category would include dark pools who under these changes would not be able to combine client orders with bilateral execution against the brokers own account.[187] This would result in the categorization of Broker Crossing Networks as OTFs hence as a result the parties operating BCNs upon the coming into operation of MiFID II must either stop trading or register as MTFs.[188]

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[183] Article 14(2) Markets in Financial Instruments Directive 2004/39/EC.
[198] Article 25 Markets in Financial Instruments Directive 2004/39/EC.
[184] Preece R 'Overhauling Europe's Securities Markets' (2012) 23 CFA Magazine
[185] Preece R 'Overhauling Europe's Securities Markets' (2012) 23 *CFA Magazine*
[186] Matteo C *Trading and dark pools of liquidity* (Università degli Studi di Padova, 2014)34.
[187] Preece R 'Overhauling Europe's Securities Markets' (2012) 23 CFA Magazine
[188] Matteo C *Trading and dark pools of liquidity* (Università degli Studi di Padova, 2014)38.

Prior to MiFID II, Broker Crossing Networks are not regulated and considered OTC markets. The amendments will force them to decide and as such modify their mechanisms to fit within the available definitions. If they opt to become MTFs they would have to open their doors to all traders irrespective of volume and therefore run the risk of exposure to toxic liquidity.[189] (Toxic liquidity is that provided by High Frequency Traders[190]) Compliance with MiFID would force them to admit traders on the basis on non-discretionary rules.[191] Alternatively they could be systematic internalizers and will have to publish their quotes for more liquid securities.[192] These above options can result in harm for institutional investors because they run the risk of trading among toxic liquidity[193] in an MTF, or lose anonymity and confidentiality because of the requirement for quote display for Systematic internalizers.

This directive focused on other aspects of investor protection and not just price. One of the measures introduced is the prohibition of platform operators to use their dark pool for their own proprietary trades.[194] It emphasises best execution[195] and client order handling[196] therefore in the execution of an order, firms must obtain the best possible result for their clients considering price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. Nevertheless, where there is a specific instruction from the client, the order shall be executed following this instruction.[197]

(b) UNITED STATES

Congress in the United States found that new data processing and communications techniques had created the opportunity for more efficient and effective market operations and it was in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure the economically effective execution of securities transactions.[213]

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[189] Order flow is toxic when it adversely selects market makers, who may be unaware they are providing liquidity at a loss. From: Easley D, López de Prado MM and O'Hara M 'Flow Toxicity and Liquidity in a High-frequency World' (2012) 25 *The Review of Financial Studies*.

[190] Easley D, López de Prado MM and O'Hara M 'Flow Toxicity and Liquidity in a High-frequency World' (2012) 25 *The Review of Financial Studies*.

[191] Article 14 Markets in Financial Instruments Directive 2004/39/EC.

[192] Matteo C *Trading and dark pools of liquidity* (Università degli Studi di Padova, 2014)42.

[193] Moloney N and Ferrarini G 'Reshaping order execution in the EU and the role of interest groups under MiFID II' (2012) 13 *European Business Organization Law Review* 560.

[194] Gabriel J 'Fifty Shades of lights in Dark Pools new regulations' ^*Fifty Shades of lights in Dark Pools new regulations* 11-10-2016 15:13 UTC, available at http://uplaw.ch/fifty-shades-lights-dark-pools-new-regulations/, accessed on 11/10/2016 15:13

[195] Article 21 Markets in Financial Instruments Directive 2004/39/EC

[196] Article 22 Markets in Financial Instruments Directive 2004/39/EC

[197] Article 21 Markets in Financial Instruments Directive 2004/39/EC [213] s11A(a)(1) Exchange Act 15 U.S.C 78k-1(a)(1).

Furthermore, there was a need to ensure fair competition between exchange markets and markets other than exchange markets. On this basis, the Securities and Exchange Commission adopted Regulation ATS (alternative trading systems)[198] and later Regulation NMS (national market system).[199][200]

To contextualise these regulations, it is necessary to look at the National Market System. In 1975, congress enacted Securities Acts Amendments. These set forth five qualities that the markets should have. They should be;

(i) Economically efficient execution transactions.
(ii) Fair competition.
(iii) Availability to brokers, dealers and investors of information with respect to quotations and transactions.
(iv) The practicability of brokers executing orders in the best market and,
(v) An opportunity for investors orders to be executed without the participation of a dealer. [216]

Congress found that these could be achieved by linking all markets for securities through information technology and hereby directed the SEC to facilitate the establishment of a national market system(NMS).[201] The NMS was established as a central market system for securities at which all buying and selling interests in these securities could participate and be represented under a competitive regime.[202] It is under this system that the succeeding regulations operate.

(i) REGULATION ALTERNATIVE TRADING SYSTEMS (ATS)

In 1998, the Securities and Exchange Commission (SEC) adopted Regulation ATS[203] to establish a regulatory framework for Alternative Trading systems. This was in response to the rapid increase in number of platforms that offered off-exchange trading of securities. These platforms traded stocks on the national market system and provided services traditionally provided by national security exchanges. These Alternative systems operate limit order books,

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[198] Regulation of Exchanges and Alternative Trading Systems Release Number 34-40760 17 CFR.
[199] Regulation NMS Stock Alternative Trading Systems Release Number 34-76474 17 CFR.
[200] Section 11C(i)-(v) Exchange Act 1934
[201] Poser NS 'Restructuring the Stock Markets: A Critical Look at the SEC's National Market System' (1981) 56 NYUL Rev.
[202] Poser NS 'Restructuring the Stock Markets: A Critical Look at the SEC's National Market System' (1981) 56 NYUL Rev.
[203] Regulation of Exchanges and Alternative Trading Systems Release Number 34-40760 17 CFR. [220] Regulation of Exchanges and Alternative Trading Systems Release Number 34-40760 17 CFR.

facilitate active price discovery, match counterparties and execute trades. Regulation ATS adopted a regulatory framework for the regulation of securities markets designed to increase the regulation of alternative trading systems.[220] This was done by changing the definition of exchange, enacting new rules and amending the existing ones relating to regulation of exchanges and broker-dealers

The SEC defines an exchange as:

'…any organisation, association or group of persons, whether incorporated or unincorporated which constitutes, maintains and provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood and includes the market place and the market facilities maintained by such exchange.'[204]

Key to the interpretation of this definition, is the SEC's distinction between an exchange and brokers, dealers or other entities is in the characteristic of centralizing trading and providing buyers and sellers with buy and sell quotations on a continuous basis. This is so that they have a reasonable expectation that they can regularly execute their orders at those price quotations.[205]

Regulation ATS defines an Alternative Trading System as any organisation, person or system that maintains, constitutes or provides a market place bringing together purchasers and sellers of securities or for otherwise performing functions commonly carried out by a stock exchange.[206] They however do not set rules governing conduct other than to do with trading on that facility and do not penalize subscribers other than by exclusion from trading.[207]

The rules and amendments under Regulation ATS allow alternative trading systems to choose whether to register as national securities exchanges under section 6 or as broker-dealers under section 15 Exchanges Act[208] and comply with additional requirements depending on their activities and trading volume. The aim being to integrate the alternative systems into the

[204] Section 3(a)(1) Securities and Exchange Act 1934.
[205] Domowitz I and Lee R 'The Legal Basis for Stock Exchanges: The Classification and Regulation of Automated Trading Systems' (May 1996) 46.
[206] 242.300 (a)(1).
[207] Section 242.300 (a) (2) Title 17 Chapter II Part 242 Regulation of Exchanges and Alternative Trading Systems Release Number 34-40760 17 CFR.
[208] Section 242.301 (a)(1) Chapter II Part 242 Title 17 Regulation of Exchanges and Alternative Trading Systems Release Number 34-40760 17 CFR.

national market system, provide for their registration as exchanges and allow the registered exchanges to better compete.[209]

In the adoption of Regulation ATS, Rule 3b-16 was enacted as part of Section 3(a) of the Exchange Act, it was designed to determine when a platform would have to register as an exchange based on the services provided. Rule 3b-16 provided a functional test as to when a trading platform would be encompassed within the definition of an exchange. Under this rule:

> '…an organisation, association or group of persons shall be considered to constitute, maintain or provide a market place or facilities for bringing together purchasers and sellers of securities of for otherwise performing with respect to securities the functions normally performed by a stock exchange if such organisation, association or group of persons; Brings together the orders for securities of multiple buyers and sellers and uses established, non-discretionary methods under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade.'[210]

This rule specifically excluded systems that traditionally perform only traditional broker-dealer activities, including; systems that route orders to national securities exchanges, markets operated by a national securities association or a broker-dealer for execution or, systems that allow persons to enter orders for execution against the bids and offers of a single dealer. Therefore, a platform that did not meet the test as stipulated was not required to register as an exchange and an alternative trading system that is in compliance with Regulation ATS was not required to register as an exchange under Section 5 of the Exchange Act.[211] This leads to the conclusion that off-market trades could be concluded by brokers and then routed to an exchange and broker-dealer dark pools could exist.

To monitor these platforms that function as alternative trading systems, the Securities and Exchange Commission requires them to be registered as broker-dealers under Section 15 of the

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[209] Section 242.300 Chapter II Part 242 Title 17 Regulation of Exchanges and Alternative Trading Systems Release Number 34-40760 17 CFR.

[210] Section 242.300 Chapter II Part 242 Title 17 Regulation of Exchanges and Alternative Trading Systems Release Number 34-40760 17 CFR.

[211] Rule 301(b) Regulation ATS Pursuant to Rule 301(a), certain ATSs that are subject to other appropriate regulations are not required to comply with Regulation ATS. These ATSs include those that are: registered as an exchange under Section 6 of the Exchange Act; exempt from exchange registration based on the limited volume of transactions effected; operated by a national securities association; registered as a broker-dealer under Sections 15(b) or 15C of the Exchange Act, or is a bank, that limits its activities to certain instruments; or exempted, conditionally or unconditionally, by Commission order, after application by such alternative trading system. For example, an ATS that is registered as a broker-dealer, or is a bank, and limits its securities activities solely to government securities is not required to comply with Regulation ATS.

Exchange Act and this obliges them to become members of an exchange.[212] They will hence have to comply with the rules of the exchange which is a self-regulating organisation. In addition to the requirements at registration prior to commencing operations, alternative trading systems under the regulation must periodically report certain information about transactions and activities that they may have carried out. They are required to report quarterly volume information about transactions for specified categories of securities and a list of all subscribers that traded through the platform in each quarter.[213] Those subject to fair access obligations are further required to provide a list of all persons, granted, denied or limited access.[231]

In addition to the above reporting requirements, the exemption from registration as an exchange is conditioned on other requirements. Under Regulation ATS, a platform that displays subscriber orders and during the preceding six months had an average trading volume of 5 percent or more of the aggregate average daily trading share volume for a given stock must provide to a national securities exchange the prices and sizes of the orders at the highest buy price and lowest sell price for such NMS stock for inclusion in the publicly available quotation data. [232] Although, they are not obliged to display trade volumes unless the volume traded exceeds 5% of the average daily trading volume of a stock.[214] In the event that they do, they will have to make their quotations public. Some authors suggest this is to temper the wouldbe effect of large anonymous trades on the overall quality of the market as the definitions of 'bid' and 'offer' were also amended in the law to include actionable Indications of Interest for the purposes of disclosure obligations.[234]

US stocks are traded simultaneously at a variety of different trading venues that participate in the national market system.[215] This increase in available trading avenues creates a need for a regulatory authority that reintegrates multi avenue information to conduct effective market surveillance to detect the likelihood of abuse or manipulation. The adoption of Regulation ATS

[212] Rule 301(b) Regulation of Exchanges and Alternative Trading Systems Release Number 34-40760 17 CFR.
[213] Rule 301(b)(9) Regulation of Exchanges and Alternative Trading Systems Release Number 34-40760 17 CFR.
[231] Rule 301(b)5) Regulation of Exchanges and Alternative Trading Systems Release Number 34-40760 17 CFR.
[232] Rule 301(b)(3)(ii) Regulation of Exchanges and Alternative Trading Systems Release Number 34-40760 17 CFR.
[214] Regulation of Exchanges and Alternative Trading Systems Release Number 34-40760 17 CFR
[234] Matteo C *Trading and dark pools of liquidity* (Università degli Studi di Padova, 2014)20.
[215] Giovanni P 'MiFID, Reg NMS and competition across trading venues in Europe and the USA' (2010) 18 *Journal of Financial Regulation and Compliance* 264.

was the first step towards the legal recognition, regulation and monitoring of alternative trading platforms other than stock exchanges.

(ii) REGULATION NATIONAL MARKET SYSTEM (NMS)

The Securities and Exchange Commission however went a step further with the adoption of Regulation National Market System (NMS). This regulation adopted 3 rules: the order protection rule, the access rule and, sub penny pricing.

The Order Protection Rule aimed to level the playing field for the investors by providing equal access to the prices and mandating that trades be executed at the best price.[216] Therefore, orders for exchange listed stocks that are not hidden cannot be traded through (ignored). In its concept release, the SEC explained that this rule requires trading centres to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution of trades at prices inferior to protected quotations displayed by other trading centres subject to an applicable exception. To be protected, a quotation must be immediately and automatically visible.[237] This, favours publicly displayed orders and aids in the process of price discovery.

The Access Rule was aimed at promoting access to quotations in stocks listed on the national exchanges, this was aimed at preventing platforms from executing orders at a price that is inferior to one displayed on another market place. The result of this rule was that an environment was created where fair and efficient access to quotes through the National Market System.[238] This was done by requiring the use of private linkages to facilitate access quotes and setting a cap on the fees charged by platforms for access to execute orders against their quotes. It also lowered the threshold required for price information from 20 percent to 5 percent of the average daily trading volume of a given NMS stock.[217] In the event that a platform does not meet this threshold, it is exempted from the disclosure of price information and therefore can legally carry out dark trading (trading without displaying the available liquidity).[218] It is this rule that provides the avenue under which dark pools function.

The Sub-penny rule prohibits market participants from displaying or accepting quotations that are priced in an increment of less than a penny unless the stock price is under a dollar. This in

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[216] Rule 611 Regulation NMS Stock Alternative Trading Systems Release Number 34-76474 17 CFR. [237] Act IRF and Burden DPRA 'SECURITIES AND EXCHANGE COMMISSION 17 CFR Part 200' (1999) [238] Rule 610 Regulation NMS Stock Alternative Trading Systems Release Number 34-76474 17 CFR.

[217] Rule 610 Regulation NMS Stock Alternative Trading Systems Release Number 34-76474 17 CFR.

[218] Bierdermann Z 'Off-exchange Trading, Dark Pools and their Regulatory Dilemmas' (2015) 60 *Public Finance Quaterly* 78.

turn meant that quotations could not be accepted unless they provided a meaningful price improvement.[219]

(c) ADDRESSSING THE POLICY CONCERNS

(i) PRICE DISCOVERY.

The loss of price discovery was one of the policy concerns raised as a disadvantage of dark offexchange platforms because the prices reflected on the consolidated tape are not a result of the actions of all the players on the market. Shorter and Miller submit that the loss of price discovery is countered in instances when the off-exchange platform does not make prices for the securities however derives it from the central exchange.[220] In several instances brokerdealer run platforms do not participate in price making but just derive it from the mid-point of the best bid and offer as quoted on the central exchange. This is not the case with electronic price makers who have mechanisms in place for price determination.[221]

Regulators therefore focus their efforts on limiting dark trading to transaction sizes that truly influence market price and on facilitating disclosure as much as possible.[222] This in turn facilitates price discovery in the lit venues. I however submit that even when these platforms are using a reference price, they obstruct the operation of the market forces of demand and supply from operating as would be the case if the whole market was aware of the availability or demand for a stock at a given price. The thresholds act to limit the scope of this.

(ii) MARKET FRAGMENTATION.

To address the concerns of market fragmentation and price discovery, the adoption of the order protection rule[223] and the access rule[224] under Regulation National Market System[225] would seem adequate. The order protection rule prevents the trading through of orders therefore a fragmented market is of no detrimental effect while the access rule gives all platforms access to all quotes available under the national market system. Although this does not take into

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[219] Rule 612 Regulation NMS Stock Alternative Trading Systems Release Number 34-76474 17 CFR.

[220] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf accessed on 10-11-2016 13:20 UTC.

[221] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf accessed on 10-11-2016 13:20 UTC.

[222] Bierdermann Z 'Off-exchange Trading, Dark Pools and their Regulatory Dilemmas' (2015) 60 *Public Finance Quaterly* 78

[223] Rule 611 Regulation NMS Stock Alternative Trading Systems Release Number 34-76474 17 CFR

[224] Rule 610 Regulation NMS Stock Alternative Trading Systems Release Number 34-76474 17 CFR

[225] Regulation NMS Stock Alternative Trading Systems Release Number 34-76474 17 CFR

consideration the below threshold and hidden trades, the requirement to report to the consolidated tape should cover this gap.

(iii) FAIR COMPETITION AND ACCESS.

The lack of uniform access to these off-exchange platforms was one of the policy concerns raised in the previous chapter, the SEC addressed this concern in both Regulation ATS and Regulation NMS by requiring Alternative Trading Systems to have non-discretionary rules when determining which parties to give access to its platform.[226] Furthermore, those entities subject to fair access requirements have to quarterly provide a list of all persons granted, denied or limited access to their platform.[227] The access concern was further addressed in Regulation NMS through the adoption of the access rule[228] which gave all platforms access to all quotes on the national market system. Irrespective of the platform an investor chose, they had access to quotes from other platforms operating in the national market system. The order protection rule[229] was also adopted and this ensures that orders that are not hidden cannot be traded through and therefore trades are executed at the best available price as displayed on any platform within the national market system.[252] It removes the ability to have orders traded through which would be execution at a worse price. Hence a broker cannot opt to route an order to a platform of their choosing when a better price is available on another platform.

These efforts by the SEC were aimed at addressing the limited access to off-exchange platforms and as a result, an investor need not subscribe to these platforms to be able to access the stocks and quotes that are available on these platforms. In Europe, the same effect of the order protection rule and the access rule was achieved in MiFID by the removal of the concentration rule which removed the requirement that orders are only routed to regulated markets.[230] Now orders can be routed to alternative platforms allowing the brokers to achieve optimal execution of client's orders. After execution of the trade it will also have to be published in the platform on which it was listed.

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[226] Article 14(1) Markets in Financial Instruments Directive 2004/39/EC.

[227] Rule 301(b)(5) Regulation of Exchanges and Alternative Trading Systems Release Number 34-40760 17 CFR.

[228] Rule 610 Regulation NMS Stock Alternative Trading Systems Release Number 34-76474 17 CFR.

[229] Rule 611 Regulation NMS Stock Alternative Trading Systems Release Number 34-76474 17 CFR. [252] Macey JR and O'Hara M 'Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective.' (1999) 28 *The Journal of Legal Studies* 17.

[230] Gkantinis S 'Regualtion and Innovation: Comparing the U.S. and European Stock Trading Markets' (2006) 13 *Harvard Law School Student Scholarship Series* 35

(iv) INVESTOR PROTECTION.

In 2014, the Financial Industry Regulatory Authority (FINRA) began requiring all offexchange platforms to report their aggregate weekly volume of transactions and number of trades by security. This was geared towards enhancing their surveillance efforts for these platforms and to monitor which of them may be subject to provisions of regulation ATS that come into effect when the percentage thresholds are exceeded.[231] These reports together with the requirement to report information to the consolidated tape aims to address the concern of transparency as more information is available to market participants and regulators. The reports to FINRA would distinguish between the different platforms and the trades carried out, making it possible to detect market manipulation.[232] I however submit that the below threshold trades are still at risk of manipulation and harder to detect due to the small volume.

Comparing the regulation United Kingdom and United States, it shows that the American perspective focuses mainly on price while the European perspective focuses on more aspects of which the price is only one. Another main distinction in manner of regulation between the two is the fact that, the US regulation distinguishes traditional exchanges which are subject to stricter rules from alternative trading systems (brokers and others subject to less stringent requirements) while in the United Kingdom and the rest of Europe, Multilateral Trading Facilities are treated in a uniform manner and all rules apply to them however they may apply for exemption to pre trade transparency requirements if they meet the stipulated conditions.[233] Furthermore, Europe doesn't have a single source of bid information but the US does via the consolidated tape which is aggregated information from all trading venues under the national market system.

I submit that in the above jurisdictions, the policy concerns raised by the authors have been addressed by the laws and regulations enacted to that effect. The succeeding chapter will look at the South African law as it is and whether there is room for off-exchange trading of securities as well as whether the policy concerns as raised need to be addressed.

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[231] Shorter G and Miller SR *Dark Pools in Equity Trading: Policy Concerns and Recent Developments* (2014) United States, *Congressional Research Service*, https://fas.org/sgp/crs/misc/R43739.pdf. accessed on 10-11-2016 13:20 UTC.

[232] Meher J, Sagar J, Owyeung C and Patro V *Equity Trading in Dark Pools* (Babson College, 2013).

[233] Bierdermann Z 'Off-exchange Trading, Dark Pools and their Regulatory Dilemmas' (2015) 60 *Public Finance Quaterly* 78.

CHAPTER 5: SOUTH AFRICAN REGULATION OF OFF-EXCHANGE TRADING.

This chapter will examine the South African law regulating the trade of securities and the avenues of security trading that are legally recognised. An analysis of the existing legal framework reveals that compared to other jurisdictions, South Africa has a very limited scope for conducting off-exchange trades of listed equity securities.

(a) THE FINANCIAL MARKETS ACT.

The Financial Markets Act[234] is the primary piece of legislation regulating financial markets. It regulates exchanges, central security depositories; to regulate and control securities trading, clearing and settlement and the custody and administration of securities; to prohibit insider trading and other market abuses.[235] The Act is administered by the Financial Services Board which is the primary regulator. This Act in turn delegates some aspects of the regulation to the exchanges which are regulated persons as defined in the Act, however they have a degree of autonomy and delegated and are referred to as self-regulating organisations (SROs). In its functioning, the FSB is supported by the Financial Markets Advisory Board and the FSB Directorate of Market Abuse.[236] The Financial Advisory and Intermediary Services Act[237] also plays a role in regulating the financial markets but its focus is to regulate the rendering of financial advisory and intermediary services to clients.[238] This governs who should be able to advise clients but not the platforms on which the trading is occurring.

The Financial Markets Act[239] defines an exchange as:

> "a person who constitutes, maintains and provides an infrastructure –
>
> (a) for bringing together buyers and sellers of securities;
> (b) matching bids and offers for securities of multiple buyers and sellers; and
> (c) whereby a matched bid and offer for securities constitutes a transaction".[240]

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[234] Section 1 of the Financial Markets Act 19 of 2012.
[235] Preamble Financial Markets Act 19 of 2012.
[236] Board FM *Reviewing the Regulation of Financial Markets in South Africa* (2011) *Treasury Department of South Africa*, http://www.treasury.gov.za/public%20comments/FMB/FMB%20policy%20document.pdf accessed on 10-05-2017 03:20 UTC.
[237] Financial Advisory and Intermediary Services Act 37 of 2002.
[238] Preamble Financial Advisory and Intermediary Services Act 37 of 2002.
[239] Financial Markets Act 19 of 2012.
[240] s1 Act 19 of 2012.

The Act makes it an offence to operate an exchange without being licensed to do so.[241] If the activities of an entity fall within the Act's definition of an exchange then it must be licenced as an exchange. If the activities do not fall within this criterion then the entity need not register. This definition is the only one in South African law that would allow a party to legally constitute and maintain an infrastructure to bring together buyers and sellers of securities. To perform the functions of an exchange an entity must be registered as such under the Act.[242] This is after an application made and the requirements have been met. The Act states that any juristic person may apply for a license as an exchange. This entity must have; the requisite assets and resources in the republic to maintain the required infrastructure, have arrangements for the efficient and effective surveillance of all transactions effected through this exchange and supervise the users to identify possible market abuse and ensure compliance with the exchange rules and directives in the Act.[243] This license, if granted, must specify the terms and conditions applicable to the exchange, categories of securities to be traded on that platform and where it operates. At the initial application, the FSB would have to approve the operational rules and the listing requirements of the exchange and this license, if granted, would need to be renewed annually.[244]

Trading shares listed on a licensed exchange is subject to the provisions of the Act[245] and other relevant subordinate legislation including the rules of the exchange on which the shares are listed. Therefore, Over-the-Counter trading structures that fall within the ambit of the Act by the nature of their activities need to be licensed or change their trading methodology that their activities do not fall within the Act's definition of an exchange. Notably, the focus of the amendments and the Financial Services Board has been on regulating the off-exchange trading of own shares by a listed company but not in instances when a third party unrelated to the company is facilitating the trade of listed securities off-exchange.[246]

A person may only carry on the business of buying or selling securities if that person; is an authorised user and acts in compliance with the relevant exchange rules, effects such buying

[241] s109(c) Act 19 of 2012.
[242] s7(1) Act 19 of 2012.
[243] s8 Act 19 of 2012.
[244] Reviewing the Regulation of Financial Markets in South Africa. Policy document explaining the Financial Markets Bill, 2011.
[245] Act 19 of 2012.
[246] Financial Services Board Response to Comments Received on the Consultation Paper: Regulation of Exchanges under the Financial Markets Act 19 of 2012.

and selling through an authorised user in compliance with the relevant exchange rules, is not an authorised user but is a financial institution transacting as a principal with another financial institution also transacting as principal or when the entity is trading securities to give effect to the restructuring of a company or group of companies. This would be a corporate finance transaction.[247] The Act also makes provision for the reporting of transactions concluded outside of an exchange by a financial institution when transacting with another financial institution and both are acting as principals or when a party concludes a corporate finance transaction to give effect to the restructuring of a company.[248]

The position of the Financial Services Board is that any off-exchange platform falling within the definition of an exchange based on its activities and not licensed as such is operating illegally.[249] The off-exchange platforms could meet the definition in the act of an exchange, that is if they maintain, constitute and provide an infrastructure; for bringing together buyers and sellers of securities, matching bids and offers for securities of multiple buyers and sellers and where by a matched bid and offer for securities a constitutes a transaction.[250] Notably though, this definition does not include the listing of these securities traded and these offexchange platforms do not provide the listing of securities. They trade in securities listed on the exchanges like the Johannesburg Stock Exchange resulting in a private law relationship based on a contract of sale. The transaction would still need to be effected through the central exchange on which the securities are listed.

(b) THE JOHANNESBURG STOCK EXCHANGE EQUITIES RULES.

At present, the Johannesburg Stock Exchange (hereafter referred to as the JSE) is the main operational stock exchange, although two other exchanges have been granted licences, the scope of this paper is only the JSE as it remains to be seen whether these new exchanges will be major players in the market. Therefore, an examination of the trade of listed securities would begin by examining of the equities rules of the exchange on which they are listed.

The purpose of the rules and directives is to achieve the objects of the JSE by providing procedures necessary to establish and regulate fair and efficient markets to ensure that the

[247] s24 Act 19 of 2012.
[248] s25 Act 19 of 2012.
[249] s109(c) Act 19 of 2012.
[250] s1 Act 19 of 2012.

business of the JSE is carried out in an orderly manner and with due adherence to the objects of the Financial Markets Act 2012, South Africa (hereafter referred to as the Act).[251]

JSE listed securities mean those included in the list of securities kept by the Johannesburg Stock Exchange. The JSE uses the call auction system where an auction trade means a transaction matched automatically in the JSE equities trading system resulting from an uncrossing at the end of an auction call session[252] whereby auction matching means the process of matching buy and sell orders according to a matching algorithm at the end of an auction session.[276] The JSE is authorised by the Act to provide for categories of authorised users, requirements for admittance as an authorised user, exclusion of authorised users, requirements for an authorised user to perform regulated services.[253] An applicant may seek to either provide trading services or custody services.

The Act defines an authorised user as a person authorised by a licensed exchange to perform one or more securities services in terms of the exchange rules.[254] The equities rules use the same definition of authorised user and defines a member as a category of authorised user admitted to the membership of the JSE under the equities rules.[255] Relevant to the scope of this paper is members carrying out trading services. A member carrying out trading services may receive client's orders where an order means an instruction from a client or sell equity securities or an instruction to amend or cancel a prior instruction to buy or sell equity securities.[256] These client orders are matched based on the following order of priority; price, whether the order is hidden[257] or visible to the market, time of entry in the central order book.[258]

The rules state that all transactions by members must be conducted through the central order book of the JSE equities trading system unless the transaction meets the criteria set out in the

[251] Section 2.30.1 Johannesburg Stock Exchange Equities Rules.
[252] Johannesburg Stock Exchange Equities Rules definitions.
[276] Johannesburg Stock Exchange Equities Rules definitions.
[253] Section 17(2)(b) Act 19 of 2012
[254] Section 1 Act 19 of 2012
[255] Johannesburg Stock Exchange Equities Rules definitions.
[256] Johannesburg Stock Exchange Equities Rules.
[257] A hidden order means an order submitted to the central order book where the order is not visible to other members and may execute in full or in part against eligible visible orders or other hidden orders. Johannesburg Stock Exchange Equities Rules definitions
[258] Section 6.10.4 Johannesburg Stock Exchange Equities Rules.

rules for an off-book trade.[259] This limits the ability of a broker to do off-market trading. The terms of such an off-book trade may be negotiated between the parties to the transaction and the purchase and sale legs of the transaction must then be submitted to the trading system by the member or members who are party to the transaction.[284] An off-book trade means a transaction in equity securities negotiated off the central order book and submitted by a member to the JSE equities trading system.[285] Off-book principal trade is a transaction where a member trades as a principal in a single equity security where the transaction has a minimum value of R500 000 and comprises of at least six times the exchange market size.[260] Such a transaction is only deemed valid once the purchase and sale legs of the transaction have been matched and confirmed by the trading system.[261]

The issue at hand is the trade of listed securities on another platform other than on the exchange on which they are registered. The equities rules of the Johannesburg Stock Exchange provide that all transactions by members must be conducted through the central order book except for transactions that meet the criteria for an off-book trade. This would seem to be the only current existing way of achieving the same practical result as an off-exchange trade by a member.

According to the Equities rules of the Johannesburg Stock Exchange, not all trades have to be executed through the central order book but may be executed as an off-book trade. The rules contain a list of these transactions.[262] These are; a book build trade,[263] a block trade[264] or a corporate finance transaction.[265] On this basis, entities with the intention of executing trades away from the central order book have this option if the transaction can fit into one of the above

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[259] Section 6.10.4 Johannesburg Stock Exchange Equities Rules.
[284] Section 6.10.2 Johannesburg Stock Exchange Equities Rules
[285] Johannesburg Stock Exchange Equities Rules definitions.
[260] Section 6.40.8 Johannesburg Stock Exchange Equities Rules.
[261] Section 6.10.3 Johannesburg Stock Exchange Equities Rules.
[262] Section 6.40 Johannesburg Stock Exchange Equities Rules.
[263] A bookbuild trade is a transaction where a member trades in a single equity security as an agent or a principal with another member in order for the second member or its clients to participate in a bookbuild. This is a price discovery mechanism by which during an initial offer, issuers do not fix a price for the securities but provide a range and depending on the demand for the units, a price is fixed. From: http://articles.economictimes.indiatimes.com/2009-08-09/news/27665381_1_book-building-issue-price-floorprice. accessed on 10-11-2016 13:20 UTC.
[264] A block trade is a transaction where a member trades as an agent or a principal in a single equity security and the transaction comprises at least the specified multiple of the exchange market size as set out in the directives. From: https://www.jse.co.za/content/JSERulesPoliciesandRegulationItems/JSE%20Equities%20Rules.pdf . accessed on 09-11-2016 17:19 UTC.
[265] A corporate finance transaction in one that must be entered into in writing and requires public notification and complies with the requirements of transactions in the listing requirements. From: https://www.jse.co.za/content/JSERulesPoliciesandRegulationItems/JSE%20Equities%20Rules.pdf .

criteria. This is however not fully off-exchange trading and the clearing and settlement of these transactions would still be carried out in the same manner as all other trades on the regulated market. When investors participate in an off-book trade on the Johannesburg Stock Exchange, the trade must be reported immediately without delay. When they take place outside trading hours, they must be reported within 45 minutes of the commencement of the next off book trade reporting session.[266] These transactions will then be ringfenced for settlement. This would be the process in terms of which linked deliveries and receipts which emanate from off book trades are separated and distinguished from deliveries and receipts which emanate from transactions in the central order book of the JSE equities trading system.[267]

All transactions must be settled electronically through Strate which is appointed by the JSE to manage the settlement of transactions in equity securities effected through the JSE equities trading system in accordance with the following principles; contract note, between the ultimate buyer and ultimate seller, on a rolling contractual basis or on a net basis. [268]

In the event of financial institutions transacting as principals, the trade would be submitted to the central securities depository for the transfer in beneficial ownership of the shares and would need to be reported to the registrar. The South African central securities depository (Strate) recognised off market orders as trades in uncertified securities that are not concluded through the Johannesburg Stock Exchange trading system and which are reported by the seller and purchaser of the uncertified securities to the relevant central securities depository participant for settlement through the central securities depository.[269] These off-market orders could be; account transfers, portfolio moves, securities lending and borrowing, corporate action types and depository receipts.[270] I submit that these category of trades is necessary for the purposes of legal and business practicality.

On the basis of section 6.10.01 of the equity rules of the JSE, it would appear that other than the off-book trades provided for, the JSE does not recognise nor permit other forms of offexchange trading of securities listed on its platform by members as it clearly states that all transactions in equity securities by a member must be conducted through the central order book

[266] Section 6.30.4 Johannesburg Stock Exchange Equities Rules. accessed on 09-11-2016 17:19 UTC.
[267] Johannesburg Stock Exchange Equities Rules definitions.
[268] Section 10.30 Johannesburg Stock Exchange Equities Rules.
[269] Directive of Strate Proprietary Limited Special Gazette No S14-2016 Strate Directive SC2. Page 8.
[270] Directive of Strate Proprietary Limited Special Gazette No S14-2016 Strate Directive SC2. Page 8.
[297] Section 6.10.01 Johannesburg Stock Exchange Equities Rules.

of the JSE Equities trading system, unless the transaction meets the criteria for an off-book trade.[297] Furthermore, even in instances where a trade meets the requirements for an off-book trade, and the terms have been negotiated, the sale and purchase legs of the transaction must be submitted to the trading system by members party to said transaction. Such a transaction would only be deemed valid once the purchase and sale legs of the transaction have been matched and confirmed by the trading system.

The equities rules are binding on members and their employees, they go further to state that the rules are binding on any person utilising the services of a member who concludes a transaction with a member in the course of the member's business.[271] Hence, members must ensure settlement of all transactions in equities effected by them through the central order book of the JSE equities trading system.[272] A member must also ensure settlement of all off-book trades in equity securities entered into as an agent on behalf of a client or as principal with a client.[273] This is however subject to an exception where either one or two members are involved and where the clients who are parties to such an off-book trade have between themselves concluded the terms of the transaction and instructed a member or members to report the transaction through the equities trading system.[274] This expressly contemplates the reporting of off-book trades between clients.

The rules as they apply to members are clear. The point of contention arises because of this exception. The provision contemplating the reporting of trades carried out off-book between persons that are not members would seem to recognise that there is a scope for listed equity securities to be traded off-exchange, not fitting the off-book criteria and not involving a member other than to report the trade. If this is the case, these transactions will only be subject to the provisions in Section 4 and 24 of the Act and ensure that the conduct does fall within the definition of an exchange.

By the application of Section 4 of the Act, no person may carry on the business of buying and selling listed securities unless that person complies with Section 24.[275] It also states that no person may in any manner directly or indirectly advertise or canvass for carrying on the

[271] Section 2.30.02 Johannesburg Stock Exchange Equities Rules.
[272] Section 10.20.1 Johannesburg Stock Exchange Equities Rules.
[273] Section 10.20.02 Johannesburg Stock Exchange Equities Rules.
[274] Section 10.20.03 Johannesburg Stock Exchange Equities Rules.
[275] Section 4(1)(b) Act 19 of 2012.

business of an authorised user unless that person is an authorised user.[276] Section 24 states that a person may only carry out the business of buying and selling listed securities if that person is an authorised user and acts in compliance with the relevant exchange rules.[277] This provision prevents persons who are not members of the JSE from carrying out the business of buying and selling listed securities unless they effect such buying and selling through an authorised user in compliance with the relevant exchange rules.[305] The exceptions to these rules apply to financial institutions transacting as principal and corporate finance transactions subject to registrar approval.[278] Financial institutions would have to report these trades in line with Section 25(2) of the Financial Markets Act.

The provisions of the Act provide limited scope for members to trade in listed equity securities off-exchange provided they do not carry out the business of trading these securities. In *Dry Good Co v Lester*, the courts defined carrying on business as;

> 'To prosecute or pursue a particular vocation or form of business as a continuous and permanent occupation and substantial employment. A single act of business transaction is not sufficient, but the systematic and habitual repetition of the same act may be.'[279]

This definition together with the previously stated provisions of the Act and the equities rules result in the conclusion that in South Africa, a person may trade in listed equity securities off the exchange on which they are listed provided their acts do not amount to carrying out a business as above defined or amount to conduct that fits within the definition of an exchange. The earlier stated explanation of the definition of an exchange by the SEC in the American jurisprudence provides clarity by stating;

> '…the distinction between an exchange and brokers, dealers or other entities is in the characteristic of centralizing trading and providing buyers and sellers with buy and sell quotations on a continuous basis so that they have a reasonable expectation that they can regularly execute their orders at those price quotations.'[280]

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[276] Section 4(1)(h) Act 19 of 2012.
[277] Section 24(a) Act 19 of 2012.
[305] Section 24(b) Act 19 of 2012.
[278] Section 24(c)-(d) Act 19 of 2012.
[279] Dry Goods Co. v. Lester, 60 Ark. 120, 29 S. W. 34, 27 L. It. A. 505, 40 Am. St. Rep. 102;
[280] Domowitz I and Lee R 'The Legal Basis for Stock Exchanges: The Classification and Regulation of Automated Trading Systems' (May 1996) 46

I submit that if an entity continuously creates a reasonable expectation that orders will be executed at a quoted price and maintains an infrastructure to meet this expectation, then their actions amount to performing the functions of an exchange. This excludes the scope for an MTF to function in stocks on the JSE.

In examining the American and European jurisprudence, the practice of internalisation came up several times. In South Africa, the Act has no mention of internalisation and neither does the equities rules of the JSE. Internalization also referred to as internalized trading is when an investor's order is filled within the brokerage firm that the order was given to from stock that is held as inventory resulting in the order not being routed to any other platform to be filled.[281] This would appear to be the same as a booked trade. The rules of the Johannesburg Stock Exchange also do not provide for internalization of listed securities therefore any party with the intention executing trades in this manner would have to apply for an exchange license. This is because their conduct would fit into the South African definition of an exchange in the Act.[282] There may however be some scope for a booked trade done by way of internal trade between clients that doesn't fall into the definition of an exchange.

In 2016, the Financial Services Board granted operating licences to two new exchanges ZAR X and 4AX. These are however not yet fully functional but should provide much needed competition to the only functional stock exchange the Johannesburg Stock Exchange. ZAR X will be the first on the continent to introduce a T+0 settlement cycles which it aims to achieve by preclearing of shareholders prior to the transaction. However, the lack of standardisation between the existing exchanges would make dual listing difficult.

Due to the advent of broad-based black economic empowerment deals there has been a growth of over-the-counter trading in South Africa. Companies needed to facilitate the ownership of their shares by black individuals. In 2014, the Financial Services Board started to clamp down on these platforms on the basis that they were illegally performing as exchanges without the requisite licensing. It is unclear why these parties were not prosecuted. These companies were given the option to register as exchanges to continue offering these services. The registrar concluded that the nature of the functions of an exchange and whether an entity is required to

[281] Ferrarini G and Recine F 'The MiFID and internalisation' (2006)

[282] The Financial Markets Act defines an exchange as a person who constitutes, maintains and provides and infrastructure for bringing together buyers and sellers of securities. Matching bids and offers for securities of multiple buyers and sellers and whereby a matched bid and offer for securities constitutes a transaction.[310] Section 1 Act 19 of 2012.

register as one is independent from the number of securities traded on that platform therefore, even when a company facilitates only the trade of its shares, it is still required to register as an exchange to be able to function legally. Therefore, a person who meets the three requirements set out in the definition[283] accordingly operates an exchange regardless of whether such the infrastructure is for one security only. Worth noting however, the Act, does not prevent an exchange from including a wide scope for off-market trades in its rules. But one would still have to avoid falling within the definition of an exchange.

CHAPTER 6: THE WAY FORWARD FOR SOUTH AFRICA.

The Financial Markets Act does not provide for the licensing of different tiers of market infrastructures and licensed exchanges with different requirements without fulfilling the functions and role of a self-regulatory organisation as outlined in the Act. The Act however empowers the registrar to grant exemptions from the provisions of a section of the Act but only if the registrar is satisfied that the application of the section will cause the applicant or clients financial or other undue hardship and said exemption will not conflict with the achievement of the objects of the Act, which include investor protection and the promotion of fair, efficient, transparent and systemically sound financial markets.[284] At this time, no entities have applied to the registrar for this exemption.

South Africa has a partially self-regulation model for exchanges. Hence, they are responsible for authorising and supervising authorised users in terms of its rules that they are bound by. It is unlikely that other platforms providing similar services would be unlikely to comply with the stringent requirements that are expected under the self-regulating model.[285] The licensing requirements to be an exchange are understandably rigorous and provide barriers to entry which in turn reduces the competition in South African financial markets.

The restrictions in the equities rules don't contemplate off-market trades of listed securities by members of the JSE other than the permitted off book trades. Since they carry out the business of buying and selling securities, if they were to maintain an infrastructure for matching buyers

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[283] An Exchange means a person who constitutes, maintains and provides an infrastructure – (a) For bringing together buyers and sellers of securities;
(b) For matching bids and offers for securities of multiple buyers and sellers; and (c) Whereby a matched bid and offer for securities constitutes a transaction.

[284] s6(3)(m) Act 19 of 2012.

[285] Financial Services Board Consultation Paper: Regulation of Exchanges Under the Financial Markets Act 19 of 2012.

and sellers, they would fit in the definition of an exchange and must register as such. Nonmembers on the other hand may carry out these trades provided it does not amount to carrying out business. I submit that creates uncertainty and leaves the issues open to consideration as to when a person would be deemed to be carrying out a business. The courts in our jurisdiction have not been called upon either to clarify this issue. The lack of uniformity in the application of the rule on off-exchange matching is undesirable.

In the United States and Europe, the regulatory authorities developed mechanisms that allow for the different execution venues that perform more limited functions. They seem to have taken the view that the benefits of recognising these platforms outweigh the concerns provided there is proper regulation. An example of this is MiFID which caters for mechanisms where settlement is achieved bilaterally. This approach promotes competition while ensuring investor protection is not compromised. The Financial Markets Act does not have a definition of these execution venues nor does it have provisions that would regulate them in a manner similar to the existing exchanges.[286]

Looking at the American approach, the regulators made it possible for the proliferation of offexchange platforms, this in in turn increased competition and led to the growth of the markets. The establishment of a national market system was key to this as it serves to bridge the information gap between the different platforms and provide a central accessible source of trading information. In Europe, the first step was to remove the concentration rule thereby allowing routing of orders to other platforms. They however did not go as far as to establish a national market system which means that although investors can access orders on these platforms, there is no central platform to which the trading information from all platforms is consolidated other than reported on the exchange on which the shares are listed.

The question however remains, whether South Africa should facilitate the creation of alternative trading avenues either in the form of crossing networks or MTFs allowing investment firms to bring together multiple interests in buying and selling interests in accordance with non-discretionary rules. To this, I in part concur with the treasury which rejected this proposal citing that these avenues would fragment the South African market which is already small compared to its international counterparts and would hinder its growth and

[286] Financial Services Board Consultation Paper: Regulation of Exchanges Under the Financial Markets Act 19 of 2012.

liquidity.[287] However, at present, an economic assessment would be required to further establish whether South Africa would benefit or suffer from fragmentation with greater competition and such as assessment should guide future legislative revisions.

Furthermore, South Africa would either need to establish a national market system or legislate with the aim of facilitating access to orders on all platforms by all investors. Either option would seem redundant considering the size of the market. Therefore, I submit that at present enforcing the law as it stands would be sufficient however, as local securities market grows, and with the advent of new exchanges, some might provide for a wide scope for off market trades. It is recommended for the Financial Services Board to consider incorporating the new technological developments in their market structure reform to catch up with the global markets.

[287] Financial Services Board Response to Comments Received on the Consultation Paper: Regulation of Exchanges under the Financial Markets Act 19 of 2012.

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