The dark side

A 'dark pool of liquidity' might sound like a Texan oilman's dream of striking it rich while drilling but in the financial services sector it refers to undisclosed trades. **Neil Ainger** looks at the rising popularity of these hidden pools in the US and wonders if they are set to take off in Europe after the arrival of the EU's Markets in Financial Instruments Directive (MiFID) last year and of various new execution venues that offer 'dark' services

Are traders moving to the dark side, shying away from the light of regulated markets like vampires avoiding the sun? If the evidence of the US is anything to go by then the answer has to be yes although, of course, it's not due to a rabid blood sucker but thanks to one of the oldest rules of the market – if you can keep your trade secret and avoid it adversely impacting the market and moving the price against you then you should.

A dark pool of liquidity can potentially allow you to do this, which is why Goldman Sachs' has its Sigma X system (one of the largest dark pools currently out there), Morgan Stanley its MS pool and UBS its PIN platform. All three banks recently signed a series of bilateral agreements that will allow their US clients to access each other's non-displayed liquidity, illustrating the rising popularity of these dark pools on the other side of the Atlantic and the need for stock exchanges to cater towards them. Much of these trades would previously have been done on the phone but traders increasingly expect to be able to carry out non-displayed trades on an electronic execution platform and to have the connectivity and capacity to push these trades through at whatever exchange they wish – a technology challenge that awaits many execution venues on this side of 'the pond' whether they are new entrants, established national stock exchanges or just internalised bank systems.

According to the US consultancy firm Tabb Group and its latest study entitled *Groping in the Dark*, dark pools of liquidity already account for approximately ten per cent of US equity volumes, with an average of 4.2 billion US shares traded daily, a figure that is rising rapidly. Some industry commentators even believe dark liquidity could eventually account for nearly half of all trades in the future, with Tabb predicting an annual growth rate of 43 per cent, and supremacy for dark pools of liquidity over traditional public limit order book stock exchange deals by 2010. The growth in the popularity of this dark liquidity may well cross the Atlantic to Europe, especially after the EU's Markets in Financial Instruments Directive (MiFID) harmonisation rules came into effect on 1 November last year, which is expected to push public disclosure of prices and best execution to the fore and, more importantly, does away with the concentration rule that previously forced participants in many countries, such as France, to only deal via their established national exchange. This artificial restriction has now been removed and a natural reaction to this might be to seek out dark pools of liquidity and other new venues in Europe where information does not have to go on a public limit order book.

"In the US there are now 40 or more dark pools and 60 or more alternative trading platforms – and that is just for equities," says Chris Smith, head of business development for NYFIX Euro Millennium, a successful US dark pool that is now launching over here in Europe.

According to Lee Hodgkinson, CEO of SWX Europe (formerly virt-x and now a wholly owned subsidiary of the Swiss stock exchange), we won't see that large number of alternative trading options in Europe yet but new venues will definitely emerge. "The incumbent national exchanges, like ourselves, will have to change and become more entrepreneurial, innovative, and adapt what we do to compete successfully." This statement is true both for ordinary 'vanilla' execution services and 'dark' services. That's why SWX Europe has done a deal with NYFIX Euro Millennium, offering its clients the opportunity to access this dark pool. "You could say that we've outsourced our dark trading service for Swiss blue chip products to them," explains Hodgkinson. "In return we get access to the NYFIX community and they get access to ours; we all therefore win."

Alasdair Haynes, CEO of ITG, a brokerage-populated technology firm with rival 'dark' offerings agrees that non-displayed trades "will be major factors in the future European trading environment". Speaking to FST earlier in the year, at the dawn of MiFID, he stated that: "Crossing and dark pools will have to feature in almost every dialogue about the changing trading environment."

History

In the US, where these dark pools arose in the late 90s, one of the initial drivers for their popularity was when the order handling rules were changed, allowing ECNs (Electronic Communication Networks) to get a market position and 'iceberg' orders – where only a small proportion of the order is visible - to gain a foothold. The process was further helped by the more recent RegNMS rules, which further

encouraged the practice. The deterioration of the relationship between the buy and the sell-side in the US, after a number of scandals such as anti-competitive tick pricing of Nasdaq securities by dealers, questionable research, information leakage and conflicts of interest over proprietary trading, also contributed to their growth. The MiFID regulations in Europe, especially the aspects aimed at encouraging cross-border 'passporting' and increased competition, could have a similarly galvanising affect over here. Other drivers for the adoption of dark pools of liquidity in Europe, and indeed for the changing execution landscape as a whole that we are seeing – what SWX Europe's Hodgkinson refers to as a "perfect storm" of contributory factors – include:

• Standardised connectivity protocols such as Financial Information eXchange (FIX) – These have completely demystified connectivity to liquidity venues.
• Algorithmic trading – The speed, power and intelligence of computing applications is growing dramatically. People are trading in ways that we couldn't even imagine three years ago and changing the market place as they do so.
• The rise of hedge funds – These are much more open and aggressive in their use of leverage and technology and are shaking the market up.

All these drivers are leading to increased competition, potentially causing fragmentation and ultimately a challenge to the prevailing economics of the industry, explains Hodgkinson. This is leading to a fall in the price of execution across Europe and tighter margins for stock exchanges, possibly adversely affecting the IT investment budget just when it is most needed to meet the challenges of a changing market place. Budgets were already suffering anyway from the deprivations of the credit crunch. Consolidation may therefore occur once the initial 'goldrush fever' to enter the new market place, and the money to remain there, has dissipated in five to ten years time.

"The end result of the 'perfect storm' that is brewing is that most European financial market participants will have to connect to many more venues than they have in the past," adds Hodgkinson. "The common FIX language protocol has removed the cost and risk of doing this however, so I don't think the extra demand for connectivity is particularly challenging. Participants will have to make the right decisions early on and choose wisely how to spend their investment dollars, especially in these difficult times of the credit crunch, but I believe the average European player will be connected to five or six different venues by the end of the year [some of which may be dark]."

Nothing new
You could argue that dark pools have always existed. "Sending an order to a New York Stock Exchange (NYSE) floor broker, having him write out the ticket and then put it in his pocket could count as one, depending upon your definition," says David Easthope, a senior analyst at the consultancy firm, Celent.

"It just happened before the practice got technological."

In a sense then dark pools of liquidity have always been with us and are nothing new. The best definition of them in their modern form though is as a non-displayed order type. "That is to say there is no information revealed prior to a trade actually occurring and there's much more limited information post trade as well," adds Easthope.

In terms of where dark liquidity resides there are a number of different sources. It can reside on crossing networks, where shares can be exchanged without parties knowing who is on the other side – potentially dangerous but still attractive. The larger brokerage firms, such as Lehman Brothers with its LX system, also have their own internalised dark pools of liquidity. A number of independent platforms, such as ITG's Posit and Liquidnet have also arisen, to offer alternative venues and indeed these independents have already taken a large chunk of the traffic in the US – a fate large investment banks will be keen to avoid on this side of the Atlantic. Broker consortiums, who don't want to pay fees and instead follow a utility model, such as the eBX LeveL platform, have also sprung up, as have tech company offerings such as NYFIX Euro Millennium. Naturally, the major exchanges are keen not to miss out on this bonanza so there are exchange-sponsored venues, or brought-in platforms, where dark liquidity might be accessed as well - for instance, NYSE Euronext's Matchpoint and Arca electronic trading platforms. The latter now has a new routing service that the exchange says involves numerous participating broker-dealers and alternative trading systems (ATS's), providing investors with access to non-displayed quotes across 29 unnamed destinations.

Market and technology impacts

All these potential venues to access dark liquidity mean that the need for more and connections is growing as the market fragments – speed is not necessarily so important, at least not at the moment for dark services, but connectivity is and good integration into order management systems is vital. After all if access to dark liquidity is on a separate terminal it'll never be used.

The fragmentation pattern seen in the US market, necessitating more connectivity and integration, is already being replicated in Europe to a lesser extent, as can be seen by the launch of new alternative trading venues here, such as Chi-X (the only one actually up and running at the moment), Börse Berlin's Equiduct, BATS, and Project Turquoise (a consortium of several leading investment banks that is expected to challenge the London Stock Exchange and other domestic exchanges). The latter two venues are due to launch in the autumn of this year and are expected to use dark liquidity pools as part of their offering. Speaking at last year's Sibos industry gathering in Boston, USA, during a session entitled *The 2013 Securities Landscape*, Adrian Farnham, a Project Turquoise spokesman who works at Morgan Stanley, confirmed that "we have found a way to electronically reconcile dark pools and other trades".

With the proliferation of new trading venues, many are predicting that there will eventually have to be a contraction with some new entrants or perhaps some of the older national stock exchanges going out of business. Alternatively some of the established players may buy up more nimble rivals who perhaps lack the money to invest in providing enough capacity to meet surging trade volumes. One thing is for sure and that's that broker-dealers will not want to be caught by the systematic internalisation rules, introduced with MiFID, which require you to reveal quotes and make them transparent to the market.

Algo trading also plays into this space with many brokers keen to use algorithms or sophisticated pieces of software to seek out dark liquidity and obliterate it as fast as they can – Credit Suisse's Sniper programme does just this. The buy-side, or fund managers acting for pension or hedge funds, will of course want to protect their liquidity and avoid sharp practices by the sell-side so a certain tension will exist. Dark liquidity aggregator algorithms are however certainly a likely future technology trend in this area. Another likely development is the spread of dark pools of liquidity into other niches. What started out as a challenge to traditional brokers in the crossing of large block trades may well spread to other areas, with dark pools becoming common in many different niches as the buy-side seeks to protect its anonymity.

Of course, the regulatory and societal differences between Europe and the US mean that the uses to which dark liquidity is put will differ but there seems little doubt that Europe is moving to the dark side as markets become more automated and transparent. Asia is likely to follow the trend too and go dark. In the end though, regulators on both sides of the Atlantic and around the world will catch up with what is going on and force dark pools of liquidity out into the light, requiring them to be more transparent and regulated as their popularity grows. This is even more likely to happen in the wake of the sub-prime crisis which has lead to increased public calls for tighter regulation but there is of course a danger in rushing in hasty regulations too quickly that may stifle a market as the Sarbanes-Oxley law did in the US. As so often happens, when and if a new law comes into force it is at this point that another alternative way to trade away from prying eyes will probably be invented by some smart player anyway and the market place will once again shift. fst

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