

Dark pools of liquidity

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Dark pools, once the domain of big-block trading, have evolved into a venue that supports high-frequency trading of smaller and medium-sized orders. They are frequently considered part of an alpha protection strategy for asset management and alternative investment firms.

However, some caution is in order since the regulatory light is now shining on dark pools. Recent increases in volume, a lack of transparency for price discovery, and the perception that the retail investor is disadvantaged have all contributed to the increased scrutiny.

Definition and structure of dark pools

The rapid development and continued maturation of the dark pool model are important factors in the evolution of the US and global market structures. Recently, more than 8 percent of all trading volume in US equities was done through dark pools, up from just 3 percent a few years ago.

A dark pool is a source of liquidity that is nondisplayed, or, in other words, does not publicly disseminate quotes. The many benefits of a dark pool include:

- Anonymous trading with minimal market impact
- Price improvement and opacity
- Lower transaction costs
- Less information “leakage”
- Access to as much liquidity as possible through technology

The nature of the dark pool industry has centered on expansion, with various ownership structures supporting many combinations of “matching” characteristics, membership complexion, and order types.

The two predominant types of ownership structures are (1) large broker-dealer-owned dark pools, which have

been successful because of consolidating of internal liquidity and opening up to external sources of order flow, and (2) exchange-owned dark pools, which have been a reactionary move resulting from loss of volume and revenue.

Three basic dark pool structures are employed by the providers:

- Scheduled crossing networks
- Continuous blind crossing networks
- Indicated markets

As for pricing, dark pools use three primary mechanisms, which set the price at which the execution will take place once two sides of a trade are matched:

- Automatic pricing (usually at the midpoint of the best bid and offer)
- Derived pricing (for example, average price during the last five minutes)
- Negotiated pricing

Dark pools have moved significantly from their initial purpose and have matured into a venue that has supported, if not created, a new investment/execution strategy: the “high-frequency” style. Although high-volume trading styles have existed in the past primarily to support statistical and risk arbitrage strategies, these new high-frequency styles operate at a much broader level that relies on speed measured in milliseconds.

As a result, liquidity and transparency in the marketplace are reduced for the small investor and enhanced for the alternative investment firms and other institutional market participants with dark pool access. Reduced liquidity may result in less opportunity for “price improvement,” wider spreads, and, ultimately, more costly executions.

Risk management practices

Because the objective of a dark pool is to reduce market impact, the risks of gaming and front-running are significant concerns of the dark pool operators. As a result, many dark pools use sophisticated antigaming logic, computer programs within algorithms that detect suspicious behavior and prevent crossing at an adverse price.

To provide clients with an additional level of assurance regarding the confidentiality of their orders, some brokers have sought independent verification of their operating procedures and processes.

Industry trends

Overall, dark pool volumes have grown steadily because of technology advances and changes in the regulatory environment promoting competition and electronic trading.

Because exchanges have seen a significant decrease in average trading volume, many exchanges see dark pools as a threat. Matching in a dark pool may allow for execution at a better price with less market impact, and dark pools have made it easier to trade small or midcap stocks that are often lower profile and harder to trade publicly (because they are less liquid). What several exchanges have done to cope with this is develop their own dark pools, in the form of anonymous crossing networks.

Although dark pools historically developed and grew substantially in popularity in the United States, these execution venues have spread rapidly recently in European and Asian markets. A factor of the dark pool proliferation among different regions appears to be their initial success, leading a large number of existing dark pools to provide investors multiple venues for trades.

The consumer interest, as measured by the corresponding volume changes in these execution venues, indicates that this trend will continue.

Competitive impact

The dark pool model is moving away from the notion of a “crossing network” and opening up to algorithms, smart routers, high-frequency traders, and exchange and retail flow. This marks a fundamental shift, from interest in dark pools as institutions for trading less liquid stocks to a new paradigm, in which high volume, liquidity, and speed appear to be the drivers.

Further, providers are using algorithms to tap into several dark pools at one time, continuing the trend of linking and partnering with each other pioneered by Goldman Sachs, UBS, and Morgan Stanley. It is still a challenge for traders to connect to multiple trading venues, hence the fragmented dark pool market. But as the partnership trend continues and smart order-routing technology advances, the market share of dark pools will continue to grow and M&A activity may be inevitable.

Regulatory debate

Along with their growth trends, dark pools have attracted heightened regulatory attention. Several questions concerning the basic nature of “hidden” liquidity, access, and cost/rebates are being reviewed by the Securities and Exchange Commission and the Financial Services Authority in the United Kingdom—which may chart the direction of these execution venues.

Specifically, concerns range from the nonstandardized reporting requirements of dark pools to the automated indications of interest (IOIs) sent among them. The IOIs are sent to seek liquidity from other dark pools to increase the executions within the original dark pool.

Some regulators believe IOIs could affect competition among trading centers and contribute even more to market fragmentation—potentially leading to development of private markets that exclude the public (i.e., retail) investor and hinder regulatory visibility into best execution rule enforcement.

Additionally, the lack of standardized reporting requirements among dark pools has led to inconsistent and unreliable volume statistics. The SEC has suggested that reporting practices, or lack thereof, present a critical transparency issue that should be given more attention. Volume from most dark pools is identified merely as nonexchange or over-the-counter trades, which may lead the SEC to impose post-trade reporting requirements on dark pools.

Further, it has been reported that New York Stock Exchange executives may consider pressing regulators in Washington to look into dark pools, which they believe are continuing to eat into trading volume of the exchange. Since dark pools fall under Regulation ATS and exchanges under Regulation NMS, dark pools have much less stringent requirements, particularly around volume reporting.

Recently, Senator Charles Schumer (Democrat, NY) told the SEC that he will move to limit “flash” orders for stocks if the agency takes no action against them.

The practice routes stock trades through private liquidity pools before they are sent to other exchanges for filling. Critics contend that flash ordering creates a two-tiered system of investors, where those with access get a better price than those without.

Conclusion

Dark pools have historically proven to be popular, useful venues for trading with less market impact for those investors interested in less liquid stocks.

To the extent they are being utilized by alternative investment companies as an important part of an execution strategy, consideration should be given to potential regulatory changes and their effect on investment philosophies that rely primarily on high-volume trading.

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