Dark Pools deliver price improvement and anonymity

Using the right tools is vital in assessing toxicity

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Volumes grow but will regulation dampen spirits?

By James Williams

Dark pools exist in a variety of forms to serve a variety of clients. In the US they are referred to as an alternative trading system (ATS). In Europe they include multilateral trading facilities (MTFs) - alternative trading venues that sprang out of MiFID regulation in 2007 - broker-owned pools called Broker Crossing Networks (BCNs) or “internalisers”. Not to mention independent dark pool operators like Liquidnet that connect buy-side to buy-side institutions.

The number of dark pool venues that now exist has risen considerably: it is estimated that there are some 45 such venues in the US alone.

As their numbers grow, so, it seems, does their popularity.

A survey by the CFA Institute found that the trading of US equities on dark pools had risen 48 per cent since 2009. Today, it is estimated that trading in these venues accounts for roughly 12 per cent of total trade volume in the US compared to 4 per cent in 2008, according to Rosenblatt Securities, an agency-only execution boutique. Specifically, Rosenblatt reported dark pool market share of 14.26 per cent in March and 14.67 per cent in April.

On the 31 March 2013, the New York Times reported that the portion of all stock trading taking place off-exchange had, that month, hit new highs, amounting to close to 40 per cent on several days. To clarify, however, this figure encompasses venues that previously operated as ATS but which are now licensed exchanges (e.g. BATS, Direct Edge) and as such are required to report to Trade Reporting Facilities.

*At the beginning of the year it was around 36 to 37 per cent. Since then it has
backed off a little bit but we’re still at more than double where we were five years ago,” says Justin Schack, managing director, Rosenblatt Securities.

Société Générale launched its dark pool, AlphaY, in April 2012, and is already amongst the largest broker-owned off-exchange venues in Europe. “Considering we’ve avoided doing anything that generates liquidity like market making it’s enabled us to become meaningful in terms of size but still retain a high quality liquidity profile that prompted us to launch AlphaY in the first place,” explains Mark Goodman, head of quantitative electronic services.

One factor that has contributed to increased usage of dark pools has been a rebound in equity markets in 2013. Benign market conditions and lower volatility means that institutional traders are more comfortable resting their orders in the dark. Goodman suggests that there is an inverse correlation between volatility and dark pool market share: “The higher the volatility the more aggressive they are about getting orders filled. Dark pool market share will generally fall during volatile markets.”

Schack shares a similar opinion: “In 2008 when the VIX index spiked up there was a disincentive to use dark pools. Since mid-2009, VIX has been on a steady march down, with the exception of a few unsustainable spikes, and is now in the low to mid teens. That has encouraged traders to direct flow away from the exchanges.”

BATS Chi-X Europe is an MTF. The difference between an MTF and a BCN is essentially client discretion; whereas a broker-owned pool can decide who can and cannot participate, an MTF has no discretionary control and is often termed “exchange-lite” as all buyers and sellers are welcome.

BATS Chi-X Europe runs two displayed (lit) order books and two non-displayed (dark) order books. As of 30 May 2013, its lit order books accounted for 24.11 per cent of the market, compared to just 2.08 per cent for its dark books. Across pan-European venues, these figures were 93.82 per cent and 6.18 per cent respectively.

Even though the dark order flow at BATS Chi-X is relatively small, “our data suggests that there has been a slight increase in dark order book trading in Europe this year”, confirms a spokesperson.

Specifically, between January 2012 and January 2013, dark order book market share climbed from 1.42 per cent to 1.77 per cent. Between March 2012 and March 2013 those figures climbed from 1.15 per cent to 1.63 per cent.

Bill White is head of equities electronic trading at Barclays Capital in New York. In his view, the fact that there are now more pools to choose from – including Barclays LX, which launched in EMEA just over two years ago – and people are getting better at executing orders and accessing these pools, means that dark pool growth is understandable.

“We have seen activity increase consecutively month on month as our liquidity aggregation on the platform has improved. We’ve invested heavily in the latency component, but it’s also thanks to how our router works and the toxicity framework that we have in place. As a result, our client base has become comfortable with how we manage liquidity in the dark venue,” says White.

What seems to be helping clients who use Barclays LX is that, even though it is a dark venue, the level of transparency offered is actually quite significant. “We show them, real-time, where we are executing orders, what the execution profile is for each order etc,” adds White.

According to the TABB rankings in April 2012, Barclays LX ranked number four behind Credit Suisse, Goldman Sachs and Knight Capital, trading 78 million shares a day. By April 2013, it held the number one position, trading 99 million shares a day.

Adds White: “We understand what execution quality and information protection means. Introducing a stable router, a low latency platform with control over liquidity profiling: all of the enhancements we’ve made over the last two years help to explain why LX has enjoyed consistent growth in the market.”

In Europe, Deutsche Bank’s own BCN, SuperX, which launched in 2010, has likewise enjoyed volume growth.

“If the liquidity experience of clients is positive they’ll come back so it creates a snowball effect and that’s really what we’ve
LIQUIDITY ON A DIFFERENT SCALE
Not all dark pools are created equal

Interview with Per Lovén

Under current MiFID regulation, pre-trade transparency waivers are used to allow non-displayed trading venues to forego the need to publish bids and offers prior to execution. With average trade size falling on these venues, often referred to as dark pools, there is a feeling among regulators and indeed exchanges, that these venues are having a negative impact on price discovery and liquidity. The danger, however, of reneging on these waivers and applying potentially broad-based regulation under MiFIR, is that all dark venues will be treated the same. In reality, they differ widely in concept, market model, and the overall value they provide.

“Not all dark pools are created equal. It’s a complex area, with different types of activity, different market participants. Let’s understand what these differences are and not treat all dark venues the same,” stresses Per Lovén, Head of EMEA Corporate Strategy & Product at Liquidnet.

Liquidnet is a unique institutional block trading venue, where buy-side institutions can trade large orders without having to declare their intentions to public exchanges. A dark pool, says Lovén, should offer value over and above what you find in the lit market: “That value tends to be realised in one of two ways: either you offer price improvements (trade within the spread, ideally at the midpoint), or you offer a way of minimising market impact.”

There are, as stated, many forms of dark pool. Liquidnet sits at one end of the spectrum as a buy-side MTF that supports block trades, and has an average execution size of around EUR900K. Moving across that spectrum you have other agency broker MTFs (e.g. ITG Posit), then the broker-dealer run internalisers – known as Broker Crossing Networks – and finally exchange/sell-side MTFs such as LSE Turquoise. The average execution size across these venues ranges between EUR30K and EUR5K.

Liquidnet’s members are typically global pension fund and mutual fund managers. According to data provided by Liquidmetrix, they save an average of 100 basis points by executing these blocks in the dark.

Were Liquidnet to be forced under regulation to provide greater pre-trade transparency, these institutions would be adversely affected by market impact. “That’s the fundamental point. Venues like Liquidnet were created because institutions were growing so big that their trading impact on the market was becoming more prevalent. If you take away such an outlet for them to trade blocks anonymously you’re going to directly lower the return and size of assets that retail investors have in their pension funds. It’s the regular guy on the street that would feel the impact of such regulation,” says Lovén.

“Policymakers and regulators are understandably concerned about the amount of trading that takes place in off-exchange trading venues that do not provide value over and beyond what the exchanges can provide. We believe that it is wrong to restrict the activity of those off-exchange venues that provide best execution and increased value to investors.

“Our Members pay a commission for trading with us but the implicit price improvement they get by minimising market impact is clearly understood. This sometimes gets lost in the wider dark pool debate.” As Seth Merrin, founder and chief executive of Liquidnet, wrote in the Financial Times on 3 May 2013: “Not all dark pools are the same and any debate on restricting their activity should recognise that some exist precisely for the reason they were formed.”
seen over the last few years,” explains Andrew Morgan, co-head equity trading EMEA at Deutsche Bank.

“Our dark pool market share has benefited as a result of recent investment in the technology as compared to some of our peers. In Q4 2012, we were the number two dark pool in Europe according to Rosenblatt. Volumes have been slightly impacted this year because we switched off our crossing capability into Italy, while uncertainty surrounded implications of the transaction tax, but we have since switched it back on.*

Between April 2012 and April 2013 the pool saw a EUR2.1billion or 15 per cent increase in volume, which shows the extent to which buy-side institutions are interacting with these dark venues. According to Morgan, the average fill size, during that same period, increased by “50 per cent”.

Another possible driver of increased activity in dark pools relates to execution fees that brokers have to pay for routing orders to the exchanges. In a nutshell, avoiding interaction with the primary market reduces costs.

“Their access fee cap is 30 cents per 100 shares under Reg NMS and a lot of the exchanges are close to, if not at, that level. Brokers therefore have an incentive to divert flow away from the exchanges to lower cost venues, many of which happen to be dark pools,” observes Schack.

“The other issue is customer segmentation. In the US, exchanges operate under the principal of fair access, meaning that they have to offer the same terms and access to their liquidity to everybody. An ATS does not have to do that. It can stipulate who interacts with who, and offers clients customised experiences.

“I’d say these are two of the biggest reasons behind the growth of dark pools in recent years.”

Anthony Godonis is senior equity trader at Aberdeen Asset Management. He notes: “Commission rates have fallen in recent years so there’s less margin available, even for the agency-only brokers. The bigger exchanges have such a high cost structure to execute that there’s no incentive to use them when the brokers can execute internally on the dark pool more cheaply.” Platforms like AlphaY are not only giving clients the opportunity to interact with high quality liquidity - hedging flow from its derivatives and Delta One business - but the ability to benefit from liquidity profiling. This is achieved by measuring the quality of liquidity in other dark venues that AlphaY interacts with, creating a liquidity spectrum that ranks the toxicity of liquidity.

As a result, buy-side clients are able to develop a more nuanced appreciation of how to trade in the dark. Rather than reduce their liquidity options by saying ‘I don’t want to interact with ‘X’ venue because of toxicity issues’, they are, in Goodman’s words, better able to recognise the fact that “all liquidity is useful some of the time but not all liquidity is useful all of the time”.

“If you’re able to measure that type of liquidity, then when you’re making trading decisions you can decide to use or not use venues on that particular basis. It means you don’t take a black and white view of things by cutting certain dark pool venues and sticking to others.”

Another reason why dark pools have blossomed in recent times is thanks to better technology, in particular dynamic smart order routers.

“A range of information is fed into our router, which then says, ‘At this given point in this name, because possibly there’s no liquidity, the best way is to post a bid on a public venue. Or maybe the profile is very liquid, there’s a lot of turnover, so let’s post at mid-point in the dark pool’. The router utilises its own dynamic decision process. LX is just another input to it,” explains White.

Deutsche Bank’s most popular algorithm with clients is Stealth, says Morgan.

“It opportunistically leverages the dark venue. When you send an order to Stealth, unless you’re using it in very specific circumstances it will typically rest your entire
order in the dark pool with a view to getting it filled subject to a minimum fill quantity.

“It’s about getting access to the right liquidity at the right time, and, importantly, at the right price.”

Even though dark pools are growing in popularity, and trading volume, regulation is lurking in the distance, which could potentially restrict the way these dark pools operate.

With average trade order sizes falling, the operators of primary exchanges are getting increasingly vocal. Their concern is that dark pools are not necessarily offering significant price improvement. A joint proposal by the SEC and the CFTC Advisory Committee is the “trade-at rule”.

This would basically force alternative venues to post displayed limit orders and provide more transparent price discovery. Any venue not displaying the National Best Bid and Offer (NBBO) would either have to execute the order with significant price improvement or else route the order elsewhere i.e. the lit market.

In Europe, regulators are now proposing a “volume cap mechanism” on off-exchange venues under the Markets in Financial Instruments Regulation. This would place a 5 per cent trading limit on every instrument traded on a dark pool. This is far from ideal for institutions who still rely on the ability to execute block trades safely and anonymously. After all, the very assets being managed by these institutions are peoples’ hard-earned pension funds.

Lee Hodgkinson is Head of Sales & Client Coverage EMEA and APAC, at NYSE Euronext. His view is that, far from being against dark pools, all the exchanges want to see is a more level playing field from a regulation perspective.

“We accept that one size no longer fits all and that there need to be alternative trading venues to meet the needs of a wide range of modern investors. It’s incorrect when people characterise us as being de facto opposed to dark pools as we are not.

“However, we do think that more oversight and transparency is needed. Dark pools and internalisers now have, on both side of the Atlantic, a competitive advantage which is obtained without contributing to price discovery.

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Lee Hodgkinson, NYSE Euronext

“MiFID II, in our view, should level the playing field with respect to the regulatory obligations that trading venues need to adhere to – with certain provisions for the wholesale market – and also to improve transparency. Not because of the competitive dynamic, but primarily for investor protection,” says Hodgkinson.

“This has had an impact on the profitability of exchanges, their market share has dropped, so they are understandably fighting their corner,” says Morgan.

“The price improvement aspect of dark pool trading isn’t just about the price that you trade at now. What’s more of a feature is the ability to manage that impact thereafter. If you’re trading opportunistically within the dark pool you can still manage your price impact over the duration of an order more efficiently than you would were you to leave a footprint on the lit market.”

Hodgkinson is clear to caveat his position with respect to the wholesale market, agreeing that block trades that could potentially move the market still need to be handled in an appropriate framework.

The bigger issue goes back to the point that many dark pools are executing smaller orders – retail flow – without transparency.

“The spirit of MiFID never intended retail transactions to be handled in private networks. We believe that there should be a limit to the transparency protection that is applied to orders. Otherwise, you’ll get to the point where nothing gets done in transparent and open markets.

“Without the retail definition in MiFID, size is the only proxy you can have,” says Hodgkinson.
AlphaY plugs liquidity gap using derivatives & Delta One hedging flows

Interview with Mark Goodman, Société Générale

The decision for Société Générale to launch a dark pool trading platform, AlphaY, in April 2012 arose from a desire to access liquidity in a safe environment that the firm felt was not readily available externally.

Prior to launching AlphaY, SocGen’s analysis of dark pools led to it developing a series of measures to analyse liquidity toxicity. Each trading venue’s liquidity was profiled to create a liquidity spectrum ranging from safe to toxic. These measures convinced SocGen that there was a gap in the quality of dark pool liquidity and as Mark Goodman, head of quantitative electronic services, explains:

“We have a lot of hedging flow from our derivatives and Delta One business. By its very nature, this is very safe liquidity so we decided we wanted to fill that gap by creating a dark pool using this flow. That was something that our clients wanted to interact with.”

AlphaY gives clients access to over 4,500 securities and is run using technology provided by NYSE Technologies. Unlike multilateral trading facilities (MTFs), which are obliged to allow all participants to access the pool, AlphaY is run as a Broker Crossing Network (BCN). “By having discretion over who can participate in the pool and who cannot, we’ve been able to construct what we feel is a very safe environment with high quality and large-scale liquidity,” confirms Goodman.

At the outset, SocGen were determined not to bring another “Me too” solution to the dark pool market. As one of Europe’s leading quant-driven brokerages the scale of hedging and Delta One flow put SocGen in a unique position for institutions to tap into a unique liquidity source. The aim, says Goodman, was not only to offer a solution where clients can cross with each other – as they had access to venues which could do that – but to “deliver incremental liquidity from our other activities that’s not available to the same extent elsewhere”.

Being a quant-driven house, SocGen has a strong research team involved in building and refining the algorithms used to source the right liquidity for clients. For institutions that use dark pools, their primary concern is liquidity but not all dark pools represent the same type of liquidity. This can lead to different results when accessing them. Rather than cutting off certain venues altogether, thereby reducing available liquidity, SocGen’s approach is to help clients recognise that “all liquidity is useful some of the time but not all liquidity is useful all of the time”.

This ties back to the liquidity measures it developed pre-AlphaY and as Goodman explains, by being able to measure the quality of liquidity it enables clients to decide which venues to choose depending on the type of trade they’re looking to initiate.

“Consider two types of orders,” says Goodman. “If a client is trading a passive order on both dark and lit venues over a period of time, most algos will allocate some portion of that trade to dark pools. This may save on the spread but it could have an impact on the residual of the order if their trade is signalled to a dark pool participant; in this case the spread saving of the dark pool is not enough to offset the increased cost of adverse selection. If you compare that to a trader who has a lot of short-term alpha in their trades, they need to execute quickly and minimise time risk.

“Their signalling costs (as a result of
information leakage) in a dark pool might be 20 basis points but their time risk might be 2 or 3 per cent. They just want to get the orders filled as fast as possible and require access to as wide a range of venues as possible.”

What SocGen is essentially doing is providing a network of liquidity to suit different trading needs at different times, thereby allowing its clients to take a more nuanced approach.

In terms of how SocGen define the quality of liquidity at other trading venues, the first measure is the immediate cost of liquidity. This involves looking at the price just before a trade is executed and just afterwards to ascertain whether or not the other counterparty had better timing.

This measure is then overlain with two factors.

“The first is information leakage, which we measure by looking at the stock volatility after the trade i.e. if the stocks get more volatile after we trade then what we’re seeing is a market reaction to our trade despite it being done in a dark pool. Our execution gave somebody information to react to.”

“The second is market impact; this measures the absolute stock direction after we trade.”

What this means is that SocGen does not merely look at the immediate cost of liquidity, but rather it tracks the lifecycle of the order in order to understand the full cost benefit of using the dark pool. In a dark pool the institution may be saving half the spread as they are executing at the mid-point and instinctively this should be borne out in improved performance.

However if the broker doesn’t take into account the impact on the entire order then they are only looking at part of the story.

“I might think I’ve saved 4 basis points because I executed at mid-point but then, because I’m leaking information and having market impact, the stock might move against me by 12 basis points over the course of the next five minutes. If you’re not looking at that you might think you’re saving in the dark pool when in fact you’re not because it’s having an impact on the rest of your order.”

Unsurprisingly, the majority of SocGen’s clients who use AlphaY rely on the trading algos its team develops. This allows for a more customised approach. By understanding what each client is trying to achieve from a trading perspective the parameters are adjusted accordingly, particularly with respect to venue selection.

“Good or bad liquidity is a relative term depending on what you’re trying to do. Because it’s a quantifiable measure the algorithm can use it to determine how much impact it’s going to have on a trade, it knows what the time risk of each trade is, and hence knows which pools to access.”

Mark Goodman, Société Générale
With dark pools appearing a lot more in media headlines this year, understanding some of the benefits, and risks, for institutions who have yet to fully engage with them, is vital.

Such has been the media coverage recently that last month Credit Suisse took the decision to stop publishing data on their CrossFinder dark pool to Rosenblatt Securities. In the context of whether dark pools are good or bad, the decision was perhaps understandable given that CrossFinder is the largest dark pool in the US.

And, staying out of the spotlight illustrates one of the core advantages of these venues: anonymity. This is especially important for institutions like mutual funds and pension funds who need to trade large blocks of stock away for the glare of the ‘lit’ markets.

“That’s what a small number of independent dark pools like Liquidnet are providing. The benefit to trading a big block with a fellow buy-side institution is that it’s going to reduce your market impact costs and information leakage to the marketplace,” explains Justin Schack, managing director at Rosenblatt Securities. However, Schack notes that as the dark pool space has evolved over time, block trading has actually become a small minority of dark pool activity.

He adds, “Mostly, now, those block trades are being sliced and diced by trading algorithms into smaller ‘child’ orders, and
the pieces are executed over time at the exchanges and various dark pools. There’s still a measure of benefit to executing those in the orders in the dark. You might not want to be on an exchange with numerous types of counterparties. Staying in the dark allows you to interact with similar types of clients and doesn’t require you to quote out loud.”

Another advantage to the buy-side community using off-exchange venues is to avoid interacting with high frequency traders. Some argue that the toxicity of order flow in dark pools is less than it is on the exchanges right now. Firms like Barclays Capital have spent time putting measures in place to help their clients’ order flow avoid interacting with toxic liquidity. Barclays LX has what is referred to as a “toxicity framework”, which involves close monitoring of all end-users providing liquidity to its clients.

“Regardless of who you are, we’ll look at your flow in aggregate and if it shows up as being toxic we’ll benchmark it into five different groups. Clients can then look at what pools of liquidity they want to trade with.

“I call it the IRS Theory. When you’re watching behaviour to that degree, behaviour changes. If an end user has been delivering low rated flow we tell them, ‘Either change it, or don’t send it here’. We give them the ability to break up their low toxicity flow versus their high,” says Bill White, head of equities electronic trading at Barclays Capital.

Toxicity, says White, is defined in Barclays LX in terms of what the price of that order was when it arrived, which then gets assessed in multiple time sheets. “Generally if someone is coming in and taking liquidity aggressively the bid is going to change. So we look at it in time series.

“We have an algorithm and a scoring methodology that basically creates a liquidity spectrum. The far left being passive and low toxic liquidity, the far right being aggressive, high toxic liquidity. As we are able to restrict HFTs interacting with our clients we’re getting the better half of their order flow (i.e. higher quality liquidity) such as hedges or low impact positions.”

Tora trading is one of Asia’s leading dark pool venues providing liquidity between buy-side to buy-side institutions. Given the nature of Asia’s markets, and where the bulk of institutional trade flow originates, Japan and Hong Kong are two of its most important markets from a trade flow perspective. Crosspoint is Tora’s native liquidity dark pool, while TSOR is the smart router that sits on top; this is what conducts flow in and out of the pool.

Chris Jenkins, managing director sales and operations, says that Tora is different to other dark pools in that the institutions participating in the pool access it via it’s Compass OEMS product “so we know their profile and also work with them to understand what they want to achieve by participating in the pool”.

“When we allow clients orders to interact with other dark venues, that’s when the toxicity issue gets interesting,” says Jenkins. “We’re connected to nine other dark pool venues for the Japan and Hong Kong market,” says Gerrit van Wingerden, managing director at Tora Trading, Japan.

“Each month, for every client we look at each fill that they’re getting in each of the venues that we’re routing to and compare how those fills do, on average, compared to the primary market in a two minute time window. If, on average, those fills are getting a similar or slightly better price the pool is “neutral”. If, on average, they are getting fills that are worse than the market, then it’s toxic. And obviously if they’re getting fills that better priced than the primary market then its less toxic.”

Like White, van Wingerden says that Tora works with the brokers running these venues.
What is toxicity and how is it measured?
Toxicity in trading terms is defined as the quality of executions in a trading venue. Toxicity analysis is a critical tool for shedding light on the value that an alternative liquidity pools can bring to the investment process. It is measured by comparing the price of executions achieved in a pool with executions occurring immediately before and after those in the primary market. Toxicity analysis and results are generally consistent across all timeframes.

While each pool has monthly variations in their toxicity levels, it's clear which pools are consistently toxic or non-toxic. In short, some pools need to be watched more than others and only accessed in limited circumstances where getting liquidity is paramount.

Is toxicity an issue for the trading community in Asia?
Toxicity is a growing issue in Asia, given the increasing amount of venues and pools available. It is not necessarily a bad thing and just because traders cross with flow that is deemed to be toxic does not mean that traders are being gamed. As knowledge and trading expertise builds in Asia, so does the richness and depth of data to analyse alternative liquidity pool execution. Traders in Asia should have the ability to see if they are achieving best execution for their trades. Toxicity analysis is useful for helping the buy-side to make informed decisions on what they are trading. It is not often made publicly available, which creates a gap in understanding the true effectiveness of these pools in achieving best execution.

How can I protect myself from a toxic pool?
Firstly, traders need to understand which pools are toxic. Then the trader needs to work out their criteria for execution in these pools. Making use of the right tools can help them make informed decisions about whether they would like to remain part of the pool or opt out.

Many alternative liquidity pool operators segment, or tier, their flow based on counterparty type. An alternative to completely opting out of pools which are measured to be toxic is for traders to opt out of crossing with particular flows.

Toxicity should not be viewed as necessarily negative, traders may be content to be trading in a so-called toxic pool, so long as they have their orders filled in a timely manner where they would otherwise have difficulty getting filled in the primary market.

What tools do we need?
Toxicity analysis and understanding the factors that affect pool quality are used by TORA to make smart decisions on the operation and rules of engagement of its pool. Ultimately the aim of any off-exchange venue is price improvement, reduced market impact and liquidity.

Advanced smart routing technologies, such as TORA’s smart order router, TSOR™, are built to enable buy-side traders to source liquidity across multiple off-exchange venues. This includes toxicity-based rules to intelligently direct flow to quality pools and posting certain types of orders to pools where that order is likely to benefit. Even relatively toxic pools have a place especially when liquidity is thin or the most important criterion is executing the order.

One thing for certain is that alternative liquidity pools are here to stay. These venues will grow to be an even more important part of the process in enabling the buy-side to deliver price improvement and liquidity while protecting anonymity. Rather than shy away from accessing alternative liquidity, it is a matter of using analysis and liquidity tools smartly to aid execution decisions and empower the buy-side trader to make a positive impact on the bottom line.
Natural Language Text:

"Industries improvement and minimised market impact, directly affecting asset growth. One hundred basis points is a big improvement for institutions that trade hundreds of millions of euros in stocks each year. "Obviously, institutions pay a commission for trading with us, but the implicit price improvement that you get by minimising market impact is clear," says Per Lovén, Head of EMEA Corporate Strategy and Product at Liquidnet.

This ability to trade safely and anonymously in the dark, without showing your hand to the lit market, means that venues like Liquidnet ultimately help to reduce volatility in the market. But not all dark pools are like Liquidnet. They come in a variety of flavours and cater for an increasingly wider client base. In the US alone it is estimated that there are around 45 dark venues. Add to that the 13 or so exchanges, and one gets a clear idea of just how fragmented, and complex, the marketplace has become.

It's that inherent complexity that is seen by some buy-side institutions to be a major disadvantage. That there are now so many smart router options and dark venues to trade in means that liquidity is drying-up. "Think about it: there are, say, 45 dark pool venues. What is the probability that someone on the other side is going to be executing the same size order to fill? It's so low. It's a very inefficient structure. A lot of buy-side firms will call their trading algorithm providers and say 'Cut off this pool and that pool because there's too much toxicity in there'. That creates an even more toxic market."

Another significant advantage to institutions that trade in the dark is price improvement. Liquidmetrix is an independent research company that, amongst other things, measures average improvement across various off-exchange platforms. Data shows that for March 2013, venues such as BATS Dark, BlockMatch, Turquoise Dark and UBS MTF delivered average price improvement of between 3.7 and 5.3 basis points. Liquidnet, which caters for institutional block trading, delivered average price improvement of 106 basis points.

"Large institutions need efficient ways to trade large blocks of stock. Using dark venues like Liquidnet, enables the end investors to enjoy significant price improvement and minimised market impact, directly affecting asset growth. One hundred basis points is a big improvement for institutions that trade hundreds of millions of euros in stocks each year. "Obviously, institutions pay a commission for trading with us, but the implicit price improvement that you get by minimising market impact is clear," says Per Lovén, Head of EMEA Corporate Strategy and Product at Liquidnet.

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"If there's a resting order on the sell side then it'll get executed but if nobody is resting any orders it's difficult, and perhaps explains why the average share size is falling. If more orders were forced to rest that would help."

Anthony Godonis, Aberdeen Asset Management
fragmented market structure. If it changed whereby we could execute more size, at more depth, that would help,” explains Anthony Godonis, senior equity trader at Aberdeen Asset Management.

Aside from the sheer proliferation of dark venues, the average order size is falling. This too is perceived as a disadvantage. As the broker-owned dark pools have an incentive to keep trade flow away from the lit markets, every order that comes through will either attempt to be matched up internally, or be sent out to third party venues. This all happens in a split second. The problem is, says Godonis, that orders are not being rested and being pinged to the dark pools with which each BCN interacts; and that means information leakage.

“If there’s a resting order on the sell side then it’ll get executed but if nobody is resting any orders it’s difficult, and perhaps explains why the average share size is falling. If more orders were forced to rest that would help. However, no matter what you trade, the high frequency aspect of the entire business means that there’s always signalling.

“These issues may seem trivial, but small execution sizes really give the higher frequency traders a window into what’s going on. If I buy 3,000 lots of a specific name, they are going to know about it. It gives them the information they need (to potentially move the market against you). It may be in a lot of smaller pieces, but it gives people an idea into what institutions are doing. It’s not hard to figure out. These pinged orders, right now, are just spraying everywhere and not resting anywhere. That’s information for someone else to trade on,” stresses Godonis.

When asked whether something like the proposed trade-at rule would help institutions like Aberdeen, Godonis adds: “Whether it’s a dark pool or a primary exchange, I don’t care where the order trades but more size needs to be available at a price. There’s no depth of execution anymore. What does it accomplish by trading 250 share lots in the dark? It the trade-at rule being talked about means that more volume gets executed then I’m all for it. It’s gotten so frustrating.”

Liquidnet’s Lovén says that the marketplace has become undoubtedly more complex and that buy-side traders today have to be execution specialists as well as market structure experts: “A lot of the brokerage firms have become more like execution consultants to large institutions. They need to understand what their clients are trying to achieve with their investment strategy and find the best solution to execute the trade within minimal market impact.”

On the signaling risk – information leakage – to using dark pools, Schack says it goes back to the fundamental conflict that brokers face i.e. the economic incentive to seek executions on behalf of clients on the lowest cost venues, with exchanges being the venue of last resort. Ironically, these are often the venues that offer the best liquidity.

“There is a danger that as a child order goes unexecuted at multiple venues, other traders learn about that order. There’s also a chance that the price might move against you while your broker is checking all these different venues to get a better deal for itself on the fee.

“So there’s information leakage risk, but also price risk. The best offer for a given stock might be USD16 on Nasdaq, for example. If your broker first checks a number of cheaper venues before eventually lifting the Nasdaq offer, the price may move and you might wind up buying at USD16.01.”

Godonis says that he’d like to see longer resting times for orders, or even a delay in the execution reporting back to the consolidated tape, so as to lessen information leakage.

And as for the proliferation of child orders being pinged all over the place, he adds: “There needs to be some sort of tool, electronically, either at the router level or the exchange level, that funnels these orders into one central place so that they can match up and trade.”

“Obviously, institutions pay a commission for trading with us, but the implicit price improvement that you get by minimising market impact is clear.”

Per Lovén, Liquidnet