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BRINGING LIGHT TO DARK POOLS

INTRODUCTION

Few pieces of information are more important to investor relations than knowing the current share price. Yet, the information displayed on your corporate website, and other public sources can be misleading. The markets through which buy and sell orders are executed, pre and post trade prices advertised, the efficiency of price formation, and indeed trading practices themselves are causing serious concern.

In early 2011, the European Commission plans to publish proposals on how to regulate the new breed of trading venues, and ensure visibility of prices. In the US, the SEC will do the same, and IOSCO (representing the global regulators) has already published its own guidelines.

How and why have the changes to visibility of share prices come about? This white paper from global3digital aims to examine how the process is changing, why these changes are important, the communities that are impacted and how regulators are responding. And as with many new technologies, a new language has been created – from dark pools, to internalisers, crossing networks and more.

global3digital aims to provide a simple guide.

BACKGROUND

The company's share price is a much watched, and yet increasingly misunderstood piece of information. On both sides of the Atlantic, new rules have been established to create competition in where and how your shares change hands. And as so often, these have had unintended consequences.

In the EU, MiFID (the Markets in Financial Instruments Directive) came into force three years ago. It allowed for the opening up of new trading systems, particularly in the equities market. MiFID's key objectives are market efficiency, market integrity, and fairness. By defining new trading venue classifications (i.e., Regulated Markets, Multilateral Trading Facilities, and "systematic internalisers") and by enabling these venues to compete on a level playing field in terms of fees, services, and technology, the Directive tries to encourage innovation, reduce trading costs for investors, and reduce the cost of capital for issuers.

In order to ensure market transparency and integrity, this Directive set up pre-trade and post-trade transparency requirements. For example, the Directive's pre-trade transparency requirements include the obligation to make public on a continuous basis current bid and offer prices and the depth of trading interests at these prices during a continuous basis during trading hours.

However the Directive also allows for the waiver of obligations for large transactions. The aim is to prevent the acquisition or transfer of a large number of shares from triggering a large increase or decrease in share prices if this order were made public.

These changes have allowed the market to create so called "Dark Pools", trading systems operating without pre-trade transparency, using the waivers provided for in the MiFID. In a dark pool, prices are advertised only after trades are done. They currently represent around 20% of trade volume on the European equity shares market, but volumes are rising. (Treat these numbers with caution; because of the lack of transparency on venue, there is no certain data).

Regulators from the FSA, to IOSCO, the European Commission and the SEC are at the beginning of 2011, focussed on how to ensure that the market continues to be 'fair'. Increasingly they are concerned that transparency has become impaired.

The growth of dark pools is also being fuelled by "high-frequency" trading, which uses computer algorithms to slice orders into ever-smaller sizes on stock exchanges and other platforms. That is causing asset managers and other institutions to direct their trades in large orders to dark pools, to minimise the risk of prices moving against them.

As orders become smaller, so the risk increases that a trader placing a large order into the market will find an order jeopardised as other traders see the order coming into the market – and move the market against it. Also, larger so-called "parent" orders placed in a dark pool are typically split off into smaller chunks, called "child" orders, and may even be worked over hours – or even a couple of days.

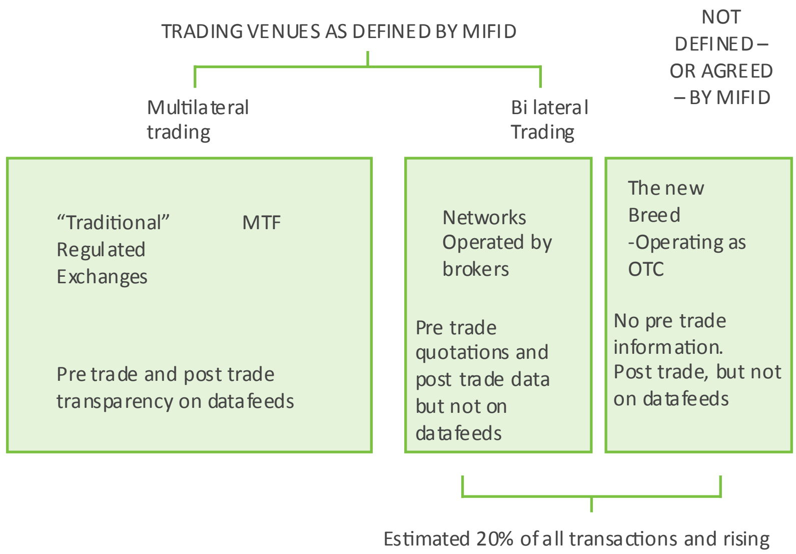
To some, using these off-exchange markets for specific purposes, is little different from the old days of the telephone-brokered, off-exchange, or over-the-counter (OTC) market. They are simply automated versions of the traditional 'upstairs' activity.

To others, because of the automation of the process, they have caused a series of problems.

TO BEGIN AT THE BEGINNING; WHAT ARE DARK POOLS?

Dark pools are simple, the use of new trading technologies to solve the age-old problem of finding the liquidity required to execute an outsized order while having the least possible market impact. In years past, large institutional orders rested in the heads of brokers and jobbers who would drip them into the market over time to limit their impact. Now they typically rest in dark pools. So dark pools are networks that allow traders to buy or sell large orders without running the risk other traders will work out what is going on and put the price up, or down, to take advantage of the order.

Pre-trade prices - the price at which shares are offered for sale - are not visible to anyone, even the participants in them, and the price at which shares change hands is only revealed after the trade is done. Nonetheless, it is important also to realise, industry experts and regulators say, that not all dark pools are the same. Some are operated by banks – and are known as "broker crossing networks". Others are run by independent operators, such as Liquidnet, which operates pools as far afield as Mexico and New Zealand in addition to the US and Europe. And exchanges themselves operate their own versions.



This makes any assessment of the pros and cons of dark pools tricky, since they do not all do the same job. A dark pool transaction can be considered at its most basic level to be an electronic equivalent of a dis-intermediated OTC transaction.

WHAT PROBLEMS DOES THIS CAUSE?

FIRST, TRANSPARENCY – LESS THAN IN 'LIT' MARKETS.

1. There is no pre trade transparency. The price and volume of firm bids and offers should generally be transparent to the public, but today are not. Regulators should also have a reporting regime for orders and trade information in venues that offer trading in dark pools.

2. Trades reported after execution are reported as Over the Counter, whether truly OTC transactions, or executed through a dark pool. These is no certainty as to where or how the trade was completed – or reported.

3. Fragmentation of the sources of prices for various shares. The post execution data available is not complete, because the rules require it to be reported through systems that are not included in the data feeds.

   In Europe, MiFID initially relied on the development of a market-led solution to aggregate post-trade data, but these are costly, partly due to the bundling of market data services by some exchanges, and many buy-side traders still find it difficult to build a complete, standardised picture of European liquidity, which can impair their ability to achieve best execution.

   The key benefits of a mandated consolidated tape would be easier price discovery, improved price and volume information for better execution.

SECOND, TRADING STRATEGIES

There is a debate in the industry over whether disclosure of trades on a real-time basis could play into the strategies of gamers and high-frequency traders.

The large institutional firms can see an awful lot of risk if there is real-time disclosure. One of the things these institutions are afraid of is that if dark pools are forced to report in real-time, people can look at the ticker and identify big trades in the shares use that to game the system. "Gaming the system" refers to quant strategies looking at trading patterns for anomalies to take advantage of market impact.

At all times, the name of the game is not to reveal who you are, or to reveal at what price you want to trade. That is market sensitive information that can be used by rivals, jeopardising your trade, and explains why prices are not made public until matches are found.

THIRD, PRICE FORMATION

There is also concern that the overall "price formation" process is being undermined as more and more trading takes place away from exchanges, where ordinary investors tend to make their trades.

Dark pools take advantage of the pricing of the public exchanges, using publicly disseminated quotes as a reference point for the initiation of trades outside of the public markets, without themselves contributing to the price discovery process. This has concerned the FSA, who, in the latest issue its publication on market conduct and transaction reporting MarketWatch, have recommended that dark pools run by multilateral trading facilities, such as Chi-X Europe's Chi-Delta, NYSE Euronext-owned SmartPool and BATS Europe's Dark Pool, suspend trading activity in the event that a reference price from the primary exchange is unavailable.

SO WHO DOES THIS IMPACT AND HOW?

ISSUERS

First, and most obviously, lack of ‘data’. Not being able to say with certainty the price at which the shares are being offered, bought and sold, is a potential nightmare. Management, other investors, news outlets, not to mention the corporate website, all need reliable data. This is especially true during key events, such as pre and post results, any corporate action, or in periods of ‘rumour’.

Data on who is trading is also key. The absence of venue, let alone who the counterparties are, restricts good IR. The ‘pattern’ of trading is also key. By splitting the orders into smaller lots, made easier by the new technologies, speculators such as high frequency traders and algorithmic traders are able to execute trades that cumulatively can swing the price of stock.

FUND MANAGERS

There is a conflict in the position of institutional investors. On the one hand, investors – as much as IRO’s – want transparency because they need to know where their transactions are relative to the market. On the other hand, they are worried about some investors – particularly short term investors taking advantage of their research to ‘game’ the system. Algorithms are being written to identify trade abnormalities, and use that information take advantage. These can be both high frequency traders, or low frequency.

In the UK, the stewardship debate continues; how do you balance of value of short term ownership. Liquidity is a good thing; volatility is not.

So on balance, Europe’s largest buy-side firms have come out in support of broker dark pools, but still crave more transparency on how orders are handled and greater clarity in classification of trading venues. Furthermore, investment managers have indicated they would prefer a more prescriptive approach by regulators to improve their overall visibility of equity market activity via post-trade data.

In the meantime, fund managers will also look to the IRO for insight.

BROKERS

Institutional investors that send orders to broker dark pools often feel inadequately informed about how orders are routed, as well as the type of non-client flow that resides in each because of the differences in crossing models and order handling practices used by the sell-side.

In both the US and Europe, ambiguity over the rules that cover broker’s internal crossing mechanisms has left the model open to interpretation, which has led to buy-side confusion on how their orders will be handled.

While many broker-operated dark pools seem to match orders similarly, there are small differences that could affect buy-side execution performance. Which is why many believe that all firms operating dark pools or broker crossing systems should disclose their order handling practices.

Brokers, too, are concerned that disclosing trades in real-time with a unique identifier could provide gamers with an edge.

WHAT ARE THE REGULATORS DOING ABOUT IT?

First, in Europe, the EU is preparing sweeping reform of share trading and transparency rules. The aim is to learn lessons from the financial crisis and play catch-up with advances in trading technology. The MiFID rules, introduced in 2007, have created competition in share trading, cut trading costs but also fragmented the market. There is likely to be a big battle between exchanges and their main customers, the banks who themselves are behind many of the new rival trading platforms.

The European Commission plans to introduce proposed rule changes in the Spring of 2011, so the following is speculation.

MARKET STRUCTURE

The EU is likely to introduce a new regulatory category of organised trading facility for all trading is outside current MiFID categories. High volume trading facilities should become a fully fledged regulated multilateral trading facilities.

There should be a new definition of automated trading, with high-frequency trading a subcategory. To trade above a certain volume would require authorisation as an investment firm. Regulators would have powers to impose minimum tick sizes on HFT orders. The multilateral trading facilities would have to put in place same market surveillance requirements as exchanges.

MARKET STRUCTURE

No major change is planned on posting pre-trade prices by dark pools, but potentially, the size of the orders for which transparency IS required, could reduce.

Post-trade share prices should be published “as close to instantaneously as is technically possible", reducing the deadline for real time reporting of executed prices from 3 minutes to 1 minute.

Regulators also recognise the need to impose more transparency on other markets such as bond markets and in particular derivatives markets.

DATA REPORTING

Due to practical and commercial obstacles, regulatory intervention will be needed to improve post-trade information to markets and facilitate consolidation of price reporting. MIFID could be amended to set up a mandatory consolidated tape for post-trading transparency that all trading venues would have to feed their prices data into.

Exchanges and trading venues would be required to "unbundle" their prices data to bring down costs of creating a consolidated tape of prices. Data would be free 15 minutes after the trade.

Others on the other hand, disagree that regulators need to intervene, and believe that the real issue is simply about agreeing a set of neutral standards as to how the tape is compiled and reported to, and the market can then do the rest.

Meanwhile in the US the Securities and Exchange Commission has also laid out a plan for reforming dark trading systems, in a bid to shed greater light on dark pool practices. These include:

- a need for actionable so called "indications of interest" sent by dark pools to be published in the same way as actual quotes;
- lowering the level at which dark pools must make quotes public to 0.25% of a stock's average daily traded volume from 5%;
- forcing dark pools to report trading volumes individually on the consolidated tape. All three proposals included an exemption for orders of $200,000 or more.

And internationally, the International Organisation of Securities Commissions has published six "draft principles" to "address regulatory concerns" over dark pools. The call is the clearest sign yet of a possible regulatory clampdown on dark pools, which match trades in private with prices only revealed after a trade is completed.

WHAT DOES THE FUTURE LOOK LIKE?

Without doubt, regulators will intervene to solve perceived problems. A consolidated tape will exist, with all venues reporting to it. But probably, real time, pre-trade prices from dark pools will not.

High frequency trading firms are likely to be regulated: the majority of HFT would be happy with some sort of regulation because they are suppliers of liquidity, they are the new market makers in the industry.

There are many parallels with the hedge fund industry. When they started, they were probably misunderstood, but nowadays hedge funds play a very important part in the investment community. Many believe same thing will happen with HFTs.

ANYTHING ELSE TO WORRY ABOUT?

PAN EUROPEAN TRADING

In five years' time, we will not be reading about FTSE 100 and CAC 40 and DAX 30. There will (finally, say some) be pan-European exchanges and a pan-European market.

SUSTAINABILITY STOCK EXCHANGES

Looking forward, we will see the emergence of stock exchanges specifically set up to trade the shares of 'sustainable' companies, imposing sustainability criteria upon their members.

This move has the back of the United Nations, through its Principles for Responsible Investment (PRI), the UN Global Compact and the UN Conference on Trade and Development (UNCTAD).

Leading the way is a report from Aviva Investors' entitled "Real Obstacles, Real Opportunities". It noted that most exchanges have sustainability based indices, some have guidelines on ESG reporting in place, and support mandatory ESG reporting in the future, while a small number already have mandatory ESG reporting in place.

The report also predicts that dedicated exchanges will be formed.

Watch this space.