

What are 'Dark Pools' for?

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Depending on who you ask, you will get different answers to the question. As ever, some context is helpful.

First, it's important to recognise what has happened to our 'lit' markets. Competition has driven trading and clearing fees lower (including rebates for firms adding liquidity to order books), allowing traders to profit from smaller bets on smaller price movements – so the prevalence of higher-frequency proprietary-trading has increased (and will continue to do so as costs fall further). At the same time, partly in the pursuit of best execution in light of the first phenomenon, and partly to reduce their own costs, brokers have increased their reliance on algorithmic trading. Both of these factors have led to an '*atomisation*' of liquidity in the market – with smaller, faster orders and trades – an environment which poses challenges for those trying to execute institutional-sized orders without being discovered or taken advantage of by short-term/momentum traders. Dark pools, with no *pre-trade* transparency, offer an alternative in which market impact should be lower, although certainty and immediacy of execution are also sacrificed.

Second, as buy-side institutions have increasingly used 'low cost execution channels', brokers have become ever more sensitive to the proportion of the commissions they earn which are paid away to exchanges, MTFs and CCPs. Broker internalisation has evolved from (expensive) sales-traders matching blocks telephonically towards (inexpensive) automated matching in broker-operated crossing networks which are free (for the broker at least) and which (by virtue of not using a CCP) don't incur clearing charges either.

For brokers executing institutional orders, two plausible answers to our opening question could be;

- *"The pursuit of best execution, as an alternative to 'atomised' lit order books"*
This rationale would work for both broker crossing networks and MTF/exchange venues
- *"Cost-avoidance and margin-preservation"*
This rationale is applicable to broker internal crossing networks only, since MTF/exchange dark pools are actually more expensive than lit books. So brokers using our midpoint book are putting the pursuit of best execution above their own margins.

It is the first of any of these answers that resonates with institutional investors, many of whom equate dark pools with less information leakage, lower market impact and better execution quality. Precisely because dark pools do not offer the same certainty or immediacy of execution offered by lit markets, institutions come to meet other price-sensitive (rather than time-sensitive) participants who care more about mitigating market impact than they do about immediacy. But institutions (and others) question whether dark pools are delivering on those promises.

And they have a point, because as soon as there's some liquidity resting in midpoint dark pools, other participants or flows (with different objectives) are attracted to participate. Anyone about to lift the offer or hit the bid in a lit market should be tempted to 'pass through' the midpoint dark pool first for 'price improvement' (especially if it's fast enough). So both for firms trading on behalf of clients and on their own behalf, there is another answer to our opening question;

- *"For price improvement against the lit market quote for aggressive orders"*

But – there's an asymmetry here – with some participants resting passive orders in dark pools to avoid 'atomised' lit markets (hoping to meet counterparties of similar patient profile), and others using them for aggressive order flow destined for those same lit markets. This asymmetry leads to the passive participants being 'adversely selected' – trading against the same aggressive/immediacy-seeking flow that they wanted to avoid, and giving up half the spread unnecessarily (as this flow might otherwise have hit their bid or lifted their offer).

Some execution venues exacerbate this asymmetry by offering aggressive routing strategies that 'bundle' access to the dark and lit order books into a single high-speed order type – effectively baking this adverse selection into their market structure. They do so because it earns them much more money (they charge both sides of the trade in the midpoint book, rather than rebating one party in the lit book), encourages the use of their (higher priced) midpoint book as a way to 'intercept' aggressive liquidity before it reaches their lit book, and reduces the average time between submission of a passive hidden order and receiving a first execution (a factor to which many broker routing algorithms are extremely sensitive).

Unlike our competitors, and despite some market demand, Turquoise does not offer such strategies. Even though it would attract more flow and increase match rates, we believe that exacerbating this asymmetry would lead to measurably poorer execution quality for those posting passively in our midpoint book, and would ultimately undermine its value proposition.

So our own answer to the opening question is;

- *"For meeting the legitimate market need for an alternative to atomised lit books, with a service that offers measurably different trading characteristics."*

It's not helping anyone to create a service which mimics lit order book characteristics with the lights turned out, and so we're prepared to forgo some short-term growth to build a differentiated market which offers a demonstrably safer place to trade institutional client orders. We invite brokers and their clients to measure the execution quality they receive in our midpoint book and to discuss the results with us.

We will return to this topic in a future post and explain some of the other ways in which we are helping brokers achieve superior execution quality in our midpoint book.

[We invite feedback from brokers, competitors, regulators and institutional investors on our approach and our views.](#)

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