Dark Pools: Friend or foe? And just how deep is that water?

with Adam van Ness

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Adam van Ness, Head of Implementation Australia and New Zealand for Russell Investment Services, discusses Dark Pools and their implications for Transition Management in Australia.

1. There has been some press lately on the growth of Dark Pools in Australia. What are they and why are they called 'Dark'?

At its most basic 'Dark Pool' refers to a liquidity source that is not typically visible to the public. Modern trading platforms and the lack of human interaction have reduced the time scale on market movements. This increased responsiveness to market price has made it more difficult to move large blocks of stock without affecting the price. Dark pools have sprung up to help large owners of capital navigate the markets and facilitate the need for trading while simultaneously minimizing market impact. Dark pools are not pre-trade transparent which means that bids and offers are not displayed prior to being traded. Hence their being called 'Dark'. Dark pools allow funds to line up and move large blocks of equities without showing their hands as to the size and direction of the overall trade. Because of the institutions involved in setting them up and running them they are often considered de-facto private exchanges.

2. Does Australia have Dark Pools? Who are they? What are they?

Dark pools exist in Australia, but are used to a smaller extent than they are in the US and Europe. There are three primary types of pool operators: broker owned, independent, and exchange owned. Most of the dark pools in Australia have been developed by institutional brokers for their upstairs trading e.g. CrossFinder (Credit Suisse), CitiMatch (Citi), Price Improvement Network (PIN - UBS), JPM-X (JP Morgan), and Sigma-X (Goldman Sachs). Independent agency firms ITG Posit and Liquidnet operate dark pools as well. And in 2010, the ASX introduced its own version of a 'dark pool' called VolumeMatch and CentrePoint to help facilitate large volume trades.

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3. Does Russell use Dark Pools in their transition management assignments? What percentage of trades overall do you trade upon them? How do you use them?

Dark pools play an important role in Russell's best execution strategies. We typically access dark liquidity 20% to 30% of the time, with that amount varying greatly on any given day. Crossing rates amongst brokers can vary significantly especially on a daily basis. A sample of four sell side brokers estimated that their internal cross rates were anywhere from 4% up to 30% - a pretty wide range. To increase the percentage crossed, we may use dark algorithms that can access over 5 different dark pools instantly, rather than having to go directly from one dark pool to another, such as CitiMatch and then to Sigma-X, and then on down the line.

Globally we traded over AUD $660 billion in transition flow in 2011. For our institutional clients it is extremely important to have the ability to access multiple dark venues.

"Dark pools are no panacea. Traders must use judgment. Engaging with a trusted implementation partner is key for clients to ensure the potential risks are mitigated."

Our dark liquidity was sourced through independent owned, broker owned, and exchange owned pools. Each pool will have its unique rules of engagement, terms of trade, and participant to which it is open. If we don't have access to a specific pool it is typically because we have made a conscious choice not to participate in that particular pool, deeming it not to be of advantage to our clients.

4. Since you are deciding to interact with the majority but not all, are some pools riskier than others? What are those risks?

Definitely, there are risks. We believe there has and always will be a legitimate role for dark pools but as with most things in life, some are good, some are bad. It is important to know who the other participants in the pool might be, who may have the ability to look through the pool and potentially game trades. The use of Indications of Interest (IOI) in some dark pools lends itself to gaming. If a gamer is trading in dark pool A and sees that dark pool B sends an IOI for stock ABC, then the gamer can infer that there is a large order for ABC. To discern direction all that is needed is to put up a small trade to determine the direction (buy or sell) of the shares behind the IOI and push the price up or down in front of this large order to make a profit. Gaming is a fact of life for all order flow, be it lit or dark. However gaming can turn a pool against the institutional client and negate any perceived benefits very quickly.

Pool providers have gotten better at detecting and throwing out gamers, but gaming can and does still exist. That being said, pool operators are incentivised to minimize any abuses because they want to see additional flow and order flow will stay away if there is a belief that the pool is toxic.

5. So do the benefits outweigh those risks? What precautions should be taken?

The benefits of trading in dark pools can outweigh the risks. This is especially true if engaging a trusted partner who has access to multiple pools, not just one or two stand alone pools operated by firms whose business models may be misaligned with the clients' interests. The benefits can outweigh the risks when proper precautions are taken regarding the business model of the dark pool operator, and efforts are made to minimize information leakage throughout the trading process.

Dark pools are no panacea. Traders must use judgment on when and how much of an order to put in a dark pool. It may be best to wait until the volatility around the open subsides before placing orders in dark. For example if you are buying and the market is clearly demonstrating weakness, it might not be best to place the entire order in dark and get filled shortly after the open as the market and/or particular stock is clearly collapsing. Fortunately the algorithms we use enable us to place a portion of a volume weighted average price (VWAP) or participate order in multiple dark pools while still interacting with the primary and alternative lit markets.

6. Any final thoughts?

The ability to have pre-trade transparency is central to a regulated exchange or market. Some may argue that by trading in the dark a subset of clients (large institutions) are not contributing to the longer-term need for price formation. However, the fact stands that large trades, once executed via a dark pool, immediately show on the consolidated tape and that price information is available for all to see.

Only when a full and complete understanding of how the Dark Pools work and a clear understanding has been developed to navigate these pools, can the client gain the full benefits of these pools. If these precautions are not taken, and the transition manager enters into just one pool uninformed, they may actually be entering shallow water and quickly run aground. By running aground we mean that the dark pool ends up exposing the institutional order flow to the broader market, or allows for gaming techniques employed by predatory firms looking to take advantage of information around large order flow. In the end, dark pools and the liquidity they provide are additional tools in the overall transition toolkit. While a potentially useful part of the trading plan, Dark Pools are not the plan.

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