

Dark pools and internal crossing engines

Assessing the value of trading in the dark

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With greater regulatory focus on the pre- and post-trade transparency of crossing networks and internal flow, in this chapter we will look at the key issues and assess the opportunities that dark liquidity pools present.

The relatively mature smart order routing capabilities available today enable market participants to negotiate the fragmentation of liquidity across classic order-driven markets, both the traditional exchanges and the newly emerging MTFs. However, at the other extreme, dark pools are still relatively unexplored territory, and present an opportunity for pioneering market players looking for the next frontier to conquer.

For those wishing to explore dark pools, it is important to remember that the term actually covers a range of ‘hidden’ and ‘hybrid’ liquidity sources. As part of the evolution of the new trade services introduced by MTFs, even

lit venues and normal order books now have the ability to conceal orders within the spread. This is the middle ground between the lit markets that can be interrogated and are completely visible to SORs, and the broker crossing, systematic internalisers and dark MTFs of the completely dark world. These ‘hidden’ orders that sit on the normal order books of lit venues remain invisible to smart order routers designed for the ‘lit’ environment, and present similar challenges for those attempting to access them.

The tools are certainly now there to support the more complex search for all forms of hidden liquidity. Smart order routers with ‘dark’ capabilities have been available for some time and, although they are not as widely used as their lit counterparts, are able to leverage both the hidden inter-spread orders of the grey markets as well as dark pools in the same algorithmic process.

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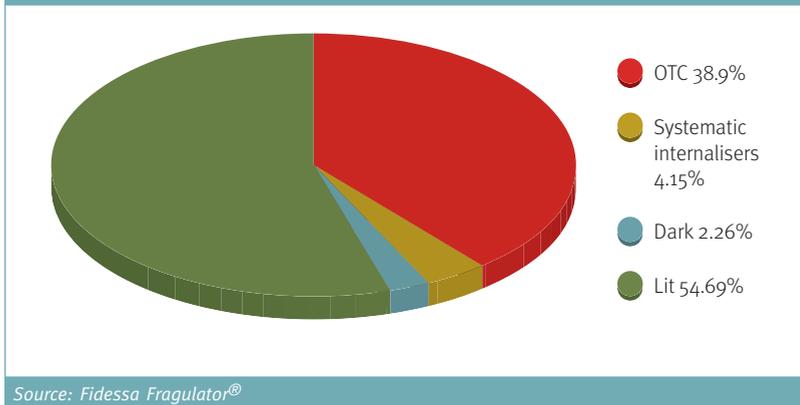
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FIGURE 1: FTSE 100: MARKET SHARE BY CATEGORY, SEPTEMBER 2010



Once we move away from the 'lit' world, however, other important factors come into play. The most notable is that, although brokers may choose to seek liquidity in as many different dark pools as they have access to, it is increasingly their own crossing network that is the first port of call. There are signs that high-margin OTC business of this nature is experiencing greater levels of electronification and there is a growing emphasis on internal crossing in block trading of institutional order flow, which follows in the footsteps of existing methods of working smaller clips of orders.

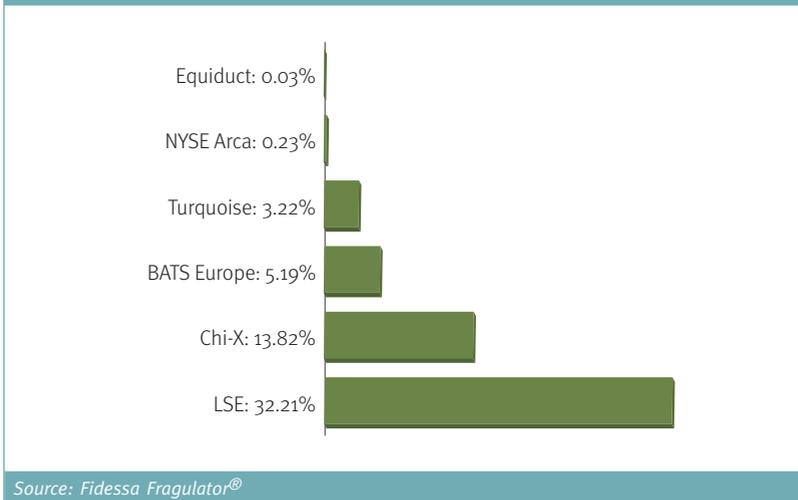
It is generally accepted that between 5% and 8% of a firm's order flows could be internalised. Brokers who access their own and

others' dark pools in combination with the use of dark SOR and dark liquidity-seeking algorithms are reporting significantly higher levels of dark pool trading than this. Institutional buy-sides are looking both for brokers to have some sensitivity around how the order is worked and for potential added value to be derived from internal crossing opportunities and interaction with dark pools.

A view of the FTSE 100 trading for September 2010 provides an interesting perspective. The graph in Figure 1 is based on data from the Fidessa Fragulator® and demonstrates the significant proportion of trading that occurs away from the lit markets.

Figure 2 through to Figure 5 show the breakdown by venue, across lit, dark, SI and OTC venues.

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FIGURE 2: FTSE 100: LIT VENUE MARKET SHARE, SEPTEMBER 2010

Dark volumes traded on MTFs are clearly interpreted and shown in Figure 3, but note the significant proportion of dark trading that is reported as OTC business (Figure 5). These volumes include business traded within broker dark pools.

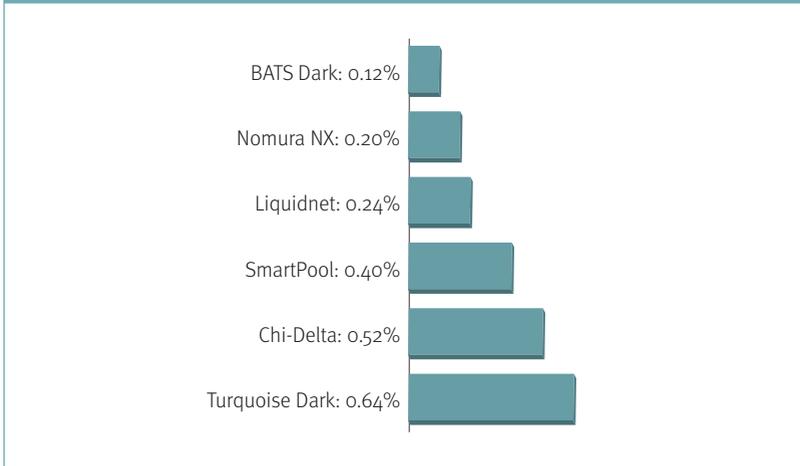
There are some obvious advantages to the expansion of internalisation and dark trading, not least of which are better execution quality, reduced market impact and cost savings. The full extent of these advantages will depend on the geography concerned and the nature of the market concerned. Nonetheless, the same principle applies: not only can brokers avoid crossing the spread to do business but they have no need

to pay exchange fees. And since many venues operate a banded cost model, reporting the trades resulting from internalisation to a regulating entity is also invariably without additional cost.

For those wishing to continue working smaller orders on external venues, while maximising opportunities to fill them internally, there is the option to shadow orders across internal and external markets. Shadowing ensures that orders are resident in the brokers' internal market, but are also actively available to the external market. It also addresses the obvious objections regarding pre-trade transparency, and the fact that internalised flow is invisible

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FIGURE 3: FTSE 100: DARK VENUE MARKET SHARE, SEPTEMBER 2010



Source: Fidessa Fragulator®

FIGURE 4: FTSE 100: SI VENUE MARKET SHARE, SEPTEMBER 2010



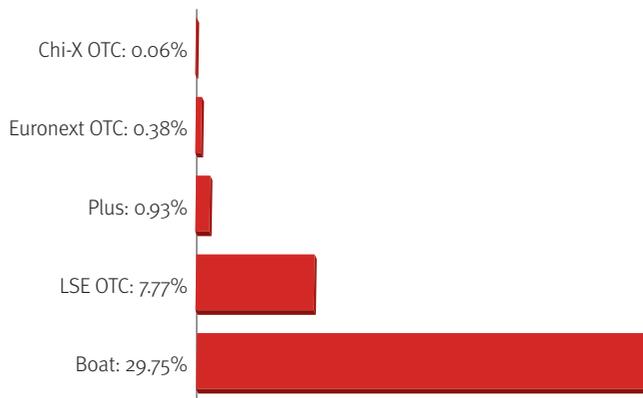
Source: Fidessa Fragulator®

and does not contribute to price discovery in the external market. Provided trades are reported in a timely fashion, the corresponding post-trade reports establish that the trades were made.

From the perspective of operating a dark pool, dark trading is not so much a single type of activity as it is a spectrum that enables market participants to

operate in a number of ways. The European example serves as a useful illustration. The MiFID directive introduced the concept of systematic internalisation and dark MTFs in addition to the existing broker dark pools. Its principles-based approach to regulation has produced numerous alternative interpretations and a complex array of different venues.

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FIGURE 5: FTSE 100: OTC REPORTING, SEPTEMBER 2010

Source: *Fidessa Fragulator®*

Once the mechanism of crossing a broker's proprietary business with internal flow raises its head, it enters the realms of systematic internalisation. But this is far from straightforward, and it was always the greyest area of MiFID's principles-based regulation, with no clear guidelines as to what precisely makes an organisation a systematic internaliser. The subsequent review (MiFID II) is intended to remedy some of these anomalies.

Market participants themselves have raised a number of concerns ranging from interpretation issues to potentially undesirable impacts on innovation and an un-level playing field between various

trade execution venues. Among buy-side firms, concerns remain about poor post-trade data quality and standards; the huge quantities of broker data that the current regime makes available renders it difficult if not impossible to analyse any expected and actual improvements.

Because of all these concerns, the current regulations are under review by CESR, and many of its proposals for a MiFID II focus on addressing current inefficiencies in the dark market space. The aim of MiFID II is to demystify venues by offering precise definitions of what constitutes crossing, what can be classified as internalisation, and what is legitimate MTF

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activity. Equally important, it will offer clarification of their respective obligations. That, plus the tightening of post-trade reporting rules will address many of the concerns that exist around quality of post-trade data. The end result is likely to be a much firmer framework, in which sell-sides will be able to explain exactly what they are and aren't doing as part of their execution policy, giving buy-sides a more accurate picture of whom, exactly, they are working with.

The final direction of the MiFID II regulation points towards detailed revisions of the pre- and post-trade regimes. Arguably, the biggest potential impact will be on the current broker dark pools – those that are not considered to be SIs or subject to SI-specific regulation under the current regime. What seems likely is that brokers who cross agency business that breaches pre-defined volume boundaries will be forced to become MTFs.

It is a trend that has already been seen in the US, where advances in technological capabilities, coupled with innovation in strategy, have also added to the impetus to change. In the dark space, the relationship between the US and the EU in terms of their relative regulatory frameworks is largely symbiotic. The evolution of dark pools and correspondent

rule changes seen in the US is influencing developments in Europe within the MiFID II framework. The European trading community is looking to the US experience – much as it did with SOR and other similar technologies – to inform its own approach.

Perhaps not surprisingly, firms across the Asia-Pacific region are looking at the cost savings seen in the US and the EU with interest, and are starting to investigate the possibilities of crossing flow over their own networks. With a far less fragmented market, exchange fees have remained comparatively high in Hong Kong, Australia and elsewhere, and as a consequence internalisation is even more attractive than it is in more fragmented trading environments.

Arguably, regulation in each of these regions will make the choice and type of interaction clearer, as well as improving transparency of the resultant volumes traded on each venue type. Firms operating dark pools in this space need to ensure that their technology is sufficiently flexible to allow them to transition between them and still meet the regulatory requirements applicable to each category of venue.

But whichever way the markets move, it is clear that the right technology will play a critical role, if firms are to adopt internalisation

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in a compliant fashion: whether that is as a broker dark pool or a fully-fledged systematic internaliser. To date this has been one aspect of the market viewed as being firmly at the high end, with only a handful of bulge-bracket brokers with sufficient resources at their disposal.

However, that situation is changing as demand increases and vendors work on addressing the needs of this rapidly changing market. Technology can be deployed in what might best be described as a 'lean' fashion as part of a package that combines smart order routing for dark, lit and hybrid markets with intelligent market access.

In fact, such a technology offering creates the most complete response to dark markets, and offers users a comprehensive solution for operating in an environment characterised by competing alternative trading venues, higher volumes, elusive liquidity, smaller average clip sizes, and greater scrutiny on market impact. It enriches algo flows, enhances TCA, reduces trade reporting costs, facilitates access to all venues regardless of their precise nature, and continues to support best execution. Most of all it brings the possibility of compliant internalisation to far greater numbers of brokers and their clients. ■

