Exposing the Identity of Dark Pools in Real Time Could Hurt Institutional Traders

By Ivy Schmerken Mar 01, 2010

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Following the financial crisis, the Securities and Exchange Commission has redoubled efforts to shine a light on opaque practices that deny investors fair access to information and potentially could damage the integrity of the national market system. But industry participants are concerned that a recent proposal actually will make matters worse.

An SEC proposal for increasing transparency into dark liquidity pools has sparked 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. In October 2009 the SEC issued a concept release detailing rules that would require real-time disclosure of the identity of dark pools and other alternative trading systems (ATSs) on the reports of their respective executed trades. The proposal would mandate that dark pools and ATSs attain specific market participant identifiers (MPIDs).

Currently, dark pools, which are members of the Financial Industry Regulatory Authority (FINRA), report their trades to a trade reporting facility, or TRF, operated by either NYSE Euronext or Nasdaq, or to FINRA's Alternative Display Facility (ADF). But these trades are identified as over-the-counter trades, so the identify of the dark pool that executed the trade is not publically disclosed.

While no rules have been finalized, SEC proposals for the regulation of dark pools -- termed "non-public trading interest" -- were made available for public comment until February 22, 2010. The commission could impose new requirements to promote visibility into the private equity trading networks.

"The large institutional firms can see an awful lot of risk if there is real-time disclosure," comments Bernard Donefer, distinguished lecturer, associate director, Subotnick Financial Services Center at Baruch College. "One of the things that institutions are afraid of is that, if dark pools are forced to report in real-time, people can look at those little footprints on the ticker and say, 'There is somebody doing big trades in this stock,' and use that to game the system," he explains. "These are quant strategies looking at trading patterns for anomalies to take advantage of market impact, and not necessarily evil people."
A Catch-22

The proposal is somewhat of a Catch-22. While traditional asset managers would like more data on which stocks are trading in dark pools, they are reluctant to leave a trail of bread crumbs for high-frequency traders to pick up. "There's too much leakage, and it doesn't benefit anyone other than high-frequency trading shops," comments Andrew Weinberg, global equity trader at PineBridge Investments in Dallas.

If the high-frequency trading shops see that a particular stock traded in a dark pool, Weinberg warns, the information could be used against the buy side. "It's probably giving too much data for them to know which dark pools to go into, and for the lack of a better word, to 'game' the liquidity," he suggests, noting that since HFT firms are using the fastest technology, they can get to the venues first and take advantage of the information. "Whereas long-only asset managers and mutual funds are looking for the best source of liquidity and for minimal impact, if you start announcing which dark pools have liquidity, there's an opportunity for fast money to game against them."

The SEC realizes, however, that disclosing the identity of ATSs could cause information leakage that would be damaging to institutions executing large block trades. Hence, the agency's proposal would protect the identity of an ATS executing a large trade with a market value of at least $200,000.

But while the SEC is prepared to make an exception for block trades, Weinberg argues that the identification of ATSs that execute smaller trades is even more of a concern. "The danger is more in the smaller pieces -- that's where you are going to see the high-frequency [traders]," he asserts. Instead of looking at the 30,000- to 40,000-share trades, HFT firms, which rapidly buy and sell shares to capture arbitrage opportunities, are more interested in the 300-share prints, Weinberg suggests.

Since the HFT strategies monitor how stocks "are reacting and behaving, imagine giving them more information about where the liquidity is," Weinberg continues. "That's going to make it even easier for them to hit one destination as opposed to hitting all the others."

Brokers that operate dark pools also are concerned that disclosing trades in real-time with a unique identifier could provide gamers with an edge. In a letter commenting on the SEC’s proposals, ITG, an agency broker that develops algorithmic trading strategies and operates the ITG Posit dark pool, expressed concern that including the identify of an ATS on its trade reports on a real-time basis may allow traders to take advantage of large orders being executed on an ATS. "ITG supports disclosing the identity of the ATS on the reports of executed trades. However, we believe that such disclosure should be done on a delayed basis, such as the end of the trading day," the company stated.

"We're against the real-time stock-by-stock disclosure. "We feel that it is too much information that can be taken advantage of by gamers," comments Dmitri Galinov, director of Credit Suisse Advanced Execution Services (AES), which operates CrossFinder ATS, the largest U.S. equity dark pool, according to Rosenblatt Securities reports.
"Basically, disclosing real-time stock-by-stock trades is going to bring more harm than good," says Galinov, noting this would be especially the case with small cap stocks. If Crossfinder is printing trades for a particular small cap stock, he explains, "The gamers will know the dark pool has a significant representation [for that stock] from institutional customers."

**Closing the Information Gap**

Some buy-side traders, however, are not comfortable with the current lack of information about where trading in dark pools takes place. "It's still a mystery," says Jeff Albright, head trader at Waddell & Reed Asset Management in Shawnee Mission, Kan. "Quite frankly, I believe if we're representing an institution as an active participant, we should be able to see where the volume is trading after the fact, just as a regular trade is reported outside of the dark."

While Albright says he's not sure if the dark pool trades need to be reported to the tape in real time, he doesn't see why a dark pool shouldn't be forced to play by the same rules as the lit markets. Currently, all dark pools must report their trades within 90 seconds to the TRF operated by either NYSE Euronext or by Nasdaq or to FINRA's ADF. Market centers (i.e., exchanges) are required to report their trade activity within 90 seconds to the **Consolidated Trade System (CTS)**, but unlike dark pools, regulated exchanges are required to publish the name of the venue on which the trade took place.

Experts point out, however, that dark pool and ATS executions are reported as OTC trades in the consolidated tape. "When you look at a TRF or the ADF, it just indicates the trade was done OTC," explains Baruch's Donefer. "You don't know if that was an upstairs trade done at Goldman Sachs or at a dark pool. You don't know if that was done by a market maker or OTC at an exchange."

In its concept release, the SEC contended that the current level of post-trade transparency for ATSs is inadequate. Though these trades are reported to the tape using the broker's MPID, it's not clear whether the trades were executed in the broker's dark pool or via its market maker desk. As a result, the dark pool volumes are lumped in with the broker-dealer's internalized volumes, say industry sources.

The SEC points out in its proposal that it wants to close the information gap between dark pools/ATSs and exchanges, whose trade reports specify the name of the exchange where the execution took place. "The commission would like to see ATSs identify who they are and do some type of post-trade reporting," says Brian Hyndman, SVP of transaction services at Nasdaq OMX.

The regulator has cited the growing share of liquidity in NMS stocks claimed by dark pools as a driver behind its efforts to shed light on their operations. While the SEC's proposal said dark pools collectively accounted for 7.2 percent of average daily volume at the end of the second quarter of 2009, Rosenblatt Securities reported that the share of consolidated U.S. equity volume on the dark pools that it tracks jumped from 7.82 percent in June to 10.15 percent in December 2009.
As the number of active dark pools has grown from 10 in 2002 to 29 in 2009, the dearth of information on their trading activity has become a growing concern for many industry participants. "Today there is no 'gold source,' " says Nasdaq OMX's Hyndman. "And a lot of firms want to report -- they want to boast that they have dark pool volume."

**Reporting Alternatives**

Few, if any, dark pool operators, however, want to report in real time, as the SEC has proposed. According to Credit Suisse's Galinov, for example, the firm prefers proposals from the New York Stock Exchange and Nasdaq to report dark pools' aggregated volumes at the end of day on their TRFs and on their individual Web sites.

To provide transparency into dark pool volumes, in late October 2009 **NYSE Euronext revealed a plan to publish dark pool trades** through the FINRA/NYSE TRF. In teaming with five of the largest operators of dark pools -- Barclays Capital, Getco, Goldman Sachs Group, Knight Capital Group and UBS AG, which accounted for 4.5 percent of the volume at that time -- NYSE Euronext planned to provide an end-of-day breakdown of volume segmented by executing venue/dark pool, notes Ray Pellecchia, managing director and NYSE spokesman. "The idea was to show the market essentially where all the trades printed on our trade reporting facility took place," he explains.

Nasdaq came out the following day with a similar plan, but both efforts currently are held up while a FINRA filing awaits SEC approval. Both exchanges said they would post the dark pool volumes on their Web sites, so the information would be free to the public.

"The dark pools don't necessarily want to report in real time," says Nasdaq OMX's Hyndman, who adds that Nasdaq would be content with some type of end-of-day reporting. According to the FINRA filing with the SEC, dark pools would voluntarily opt-in, agreeing to identify their trades. "It's likely to be more of an aggregated number, though it may evolve into something that's more granular," Hyndman predicts.

But Credit Suisse feels that end-of-day reporting is not appropriate for highly illiquid stocks in which it takes an institution three or four days to acquire a position. "We feel that [for] small cap stocks, even end-of-day disclosure would be too much information leakage," explains the firm's Galinov, who says he favors end-of-week reporting for small cap stocks.

In addition to concerns regarding the timing of trade reports, some industry participants believe the reporting should be anonymous. Baruch's Donefer suggests that rather than report ATS trades as simply "OTC," perhaps it would be better to indicate on the ticker that the trade occurred in a dark pool. He acknowledges, however, that there is a need for greater transparency.

"There is some value to publically disclosing where the trading is taking place," Donefer says, noting that it would help institutions fine-tune their smart routers in terms of where to look for liquidity. "The downside,' he cautions, "is that, if people see dark pools are trading more shares, they may send more order flow there and end up further amplifying the amount of trading going away from other ATSs and exchanges."
Worried about information leakage, PineBridge's Weinberg supports the view that trade reports should be anonymous, but he agrees that they should reveal that the venue is a dark pool without disclosing the identity of the specific venue. "It doesn't matter which dark pool it is per se, but more that it's trading in the dark," says Weinberg. He points out that most asset managers are currently using dark pool aggregators to get exposure to the various dark pools, and as such, they don't need to see if a stock is active in particular dark pool because the smart order router/aggregator will find it.

Still, others are pushing for full transparency into dark pools. Waddell & Read Asset Management's Albright wants to see trades executed in dark pools reported in the consolidated tape alongside trades executed on lit venues. "My purpose in using a dark pool is to access the liquidity of the dark pool," he says. "Once your trade is done, why not display your trade on the tape?"

There also are different opinions on the Street as to whether dark pools should break down their volume stock by stock or report the total shares traded as aggregated volumes. The SEC specifically has asked industry participants to comment on this point.

In a comment letter released Feb. 23, ITG rejects the view that the ATS should report all of the execution reports for a particular stock on an aggregated basis (i.e., one figure showing the total volume of shares executed in a particular stock on that ATS). "We strongly assert that this disclosure should be furnished on a disaggregated basis -- i.e. trade by trade -- and with no exemption for block executions in order to provide the marketplace with the maximum amount of information," the company stated. "ITG would also recommend that this post-trade reporting requirement be extended to all participants who effect executions, not just ATSs."

**For Regulators' Eyes Only**

While the SEC is expected to rule on dark pool trade reporting sometime this spring, Baruch's Donefer raises an interesting possibility: real-time reporting to regulators but delayed reporting to the market. "The data should be collected for any trade in every stock and should be available to the regulators in real time but not disclosed publically until the end of the day," he contends.

Credit Suisse's Galinov says his firm doesn't mind disclosing the information to the regulator in real time. "We're not worried about displaying the information to the regulators in real time so they can run their tests," he relates. "What people have problems with is publishing real-time stock information to the overall market. The gamers can be low frequency or high frequency -- it's just the intent."

Baruch's Donefer notes that while the SEC proposal is intended to increase transparency into dark pools, it's also intended to standardize dark pool reporting practices. In addition to the TRFs, most of the major dark pools and ATSs report their trades to TABB Group, the financial market advisory firm, and to Rosenblatt Securities, the institutional agency broker. These firms adjust the data for double counting and analyze the dark pools' market share. But Nasdaq's Hyndman suggests that more formal reporting would benefit the market. "If the data came from the exchange TRF," he says, "everybody would know that's the gold source."