

Investor's Business Daily

## Dark Pools Let Big Institutions Trade Quietly

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As global stock markets gyrate wildly, institutional traders continue to shift trading from public exchanges to private networks -- called dark pools -- that are mostly closed to retail investors.

Dark pools arose in less volatile times, before the financial crisis reared its ugly head. They enable institutional investors to buy or sell large blocks of stocks while keeping pre-trade price and volume concealed.

Some 40 dark-pool trading networks operate in the U.S., including internal systems launched by broker-dealers. Dark-pool exchanges now account for 8% to 10% of overall daily trading volume in the U.S. That market share could double by 2011, say research firms.

For regulators, the big question is whether retail investors are being harmed by the rise of dark pool trading. Critics argue that private, dark-pool exchanges reduce the information public markets use to set stock prices and make volume-reporting, critical to technical analysis, less transparent.

So far, the Securities and Exchange Commission has steered away from regulating dark-pool exchanges.

Regulators have viewed the rise of alternative trading systems favorably. One reason is that they provide competition to public markets by setting lower trading fees.

Institutional investors say dark pools simply let them execute trades without impacting the public market.

"Dark pools sound ominous, but they're not necessarily a bad thing for individual investors," said William Cline, principal of consultancy Cline Group.

"Liquidity has become very fragmented. Some of it is light, at the traditional exchanges, and some of it is dark, and not publicly displayed."

Traditional exchanges like the New York Stock Exchange must publish their best quotes. Unlike some electronic trading platforms, private, dark-pool networks do not display quotes to public markets. That's the reason they're described as dark.

For institutional investors, the upside to using dark pools is this: their identity and order size isn't known. As institutions amass shares, they don't have to worry that savvy traders will spot their moves and disrupt pricing for stocks as orders are being filled.

### Liquidity Concerns

For individual investors, one possible downside to dark-pool trading involves small- and midcap stocks. Dark-pool networks could make those stocks harder to trade for retail investors. That's because institutional investors would suck up liquidity via dark pools.

"As dark-pool volumes grow, market participants and regulators are paying more attention to whether this (trend) is a good thing for price discovery, market structure, and whether all investors should have access to dark-pool liquidity," said Justin Schack, a VP at Rosenblatt Securities, which tracks dark-pool volume. "But I don't think regulators are close to doing anything."

But dark pools' secrecy is a problem, says Ralph Acampora, the New York Institute of Finance's director of technical analysis studies.

"There's an ability to hide; people should be concerned about it," he said. "You don't know where the (market) forces are coming from. In the past, you could identify it. Now it's a netherworld."

Reg NMS requires that orders be executed at the best price available, no matter where they're published. The rule also says that any trading venue that exceeds 5% of average U.S. daily equity volume of any given stock must display open quotes to the broad market.

Some big dark-pool trading platforms, such as Liquidnet, have obtained exemptions from the 5% rule. Most dark-pool exchanges fall below the 5% threshold.

Buy-side traders may be helping them by splitting their orders among dark pools. Institutions are big users of computer-based trading tools, which slice orders into small chunks.

Quotes aren't available from dark-pool exchanges, but they must report trades over 100 shares.

"Eventually information comes out, but it's after the fact," Cline said. "I don't think it's easy for an individual investor to gauge the broader demand and supply balance for a particular issue, that's for sure."

Dark pools publish the price and size of trades. But, the "tape" doesn't say if a dark pool executed the trade.

"If a stock is getting traded in dark pools, trades will show up in consolidated volume figures," said Shack. "But, it's not separated out. It's not clear how much trading takes place in public or private exchanges."

Dark pools don't break out their own volume by stock. Some observers say dark pools are part of a bigger trend -- market fragmentation -- as trading venues proliferate.

"When I look at the volume on the NYSE that's irrelevant nowadays," said Joseph Saluzzi, a partner at Themis Trading, a buy-side advisory firm.

"What I look at is volume on NYSE-listed shares. That can be spread out among various ECNs and dark pools."

One place Saluzzi turns to for data is Kansas City, Mo.-based ECN operator Bats Trading, the No. 4 U.S. equities exchange.

Acampora agrees. He says investors should look at volume reports from the NYSE's Arca electronic trading platform. It interacts with dark-pool networks.

#### Price Discovery

Some dark pools, such as Liquidnet Holdings and BIDS Holdings, match up buyers and sellers that negotiate deals one-on-one.

Many dark pools use public exchanges to set prices. They match orders between buyers and sellers at the midpoint 15f bid and ask prices on public exchanges.

Some observers wonder whether institutional investors will have a lesser role in setting prices on public exchanges as their trades shift to dark pools.

"Are we getting the right price discovery if more trading isn't visible?" asked Bernard Donefer, a professor at Baruch College in New York.

"It may not be a problem today. But, will it three or four years from now?"

Some analysts say that with dark-pool exchanges accounting for 8% to 10% of U.S. daily trading volume, they're not yet a problem. But that could change if dark-pool share reaches 20% or more.

"It's not really at a point where the SEC needs to take action," said Matthew Samelson, analyst at Boston-based Aite Group. "The execution volume on a stock-by-stock basis that's occurring in dark venues isn't really substantial enough to say that prices in the displayed market aren't representative of what's out there."

Donefer says that dark-pool volume has been overblown. He says dark-pool exchanges often double-count both sides of a trade.

By overstating trading volume, he says dark pools seek to drum up more business from buy-side investors. Liquidnet, which plans an IPO, and Morgan Stanley have proposed standards for dark-pool-volume reporting.

Dark-pool trading is spreading from the U.S. to Europe, Cline says.

Dark-pool volume is getting a big boost from Goldman Sachs, Merrill Lynch and other brokerages.

"The big broker-dealers, those that still exist, all have internal dark pools that they're trying to put their proprietary order flow into," said Cline.

The SEC did not respond to requests for an interview.

Harvey Pitt, former SEC chairman who now runs consultancy Kalorama Partners, thinks it's too early to regulate dark pools.

"There are issues that need to be considered," he said. "One of them is whether the public should be allowed to participate in (dark pools). My view on that is no. I don't think everybody gets to be allowed in every transaction, where size matters."

Liquidnet is one of the few dark pools that provides limited access to outsiders.

