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For Dark Liquidity Pools, Transparency Is a Must

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Dark liquidity pools may be an increasingly vital part of the execution landscape, but they are essentially built on trust, says Bernard Donefer, associate director of Baruch College's Subotnick Financial Services Center. A dark pool "goes to zero immediately if anyone thinks there's anything untoward going on," he notes.

Which is one reason sell-side firms devote serious resources to assuring buy-side clients that orders are kept confidential. Credit Suisse's Advanced Execution Services (AES) unit, which runs the CrossFinder platform, is audited every 18 months by PricewaterhouseCoopers. "This has been a big selling point for us," says AES director Eugene Choe. While the preliminary audit was painful, "we're in the third iteration and we think it's important enough to keep going through it."

Among other things, the audits show that AES is not gathering information to trade against clients in its dark book. That such efforts are necessary is a sign of the anxiety in the marketplace, says Donefer, adding that rumors often spread about one destination or another. And with volumes continuing to rise, the stakes are high for venues to promise clients a degree of transparency.

Goldman Sachs' Sigma X is the largest U.S. dark pool, with a 23.4 percent share of volume in September, according to Tabb Group; CrossFinder had 14.7 percent. Goldman has "iron-clad procedures" that keep Sigma X orders separate from the firm's upstairs flow, says Rishi Nangalia, head of business development for Goldman Sachs Electronic Trading (GSET). The trading unit operates "as two different broker-dealers, with a Chinese wall in between," says Nangalia.

GSET is audited by the Securities and Exchange Commission constantly, says Nangalia, to ensure that the order flow remains separate. "We don't mix the businesses," he says. "We're an agency matching engine and we never compromise that."

Everyone gets audited by the SEC, says Donefer. "Everyone who uses ATSs, ECNs, brokers' pools-the entire business model works on unsullied reputations." Though dark pool operators have different business models, they all work to "ensure that orders are never shopped, that information isn't advertised, and that information is never seen by traders or sales reps," he says.

Selective Services

Indications of interest (IOIs), which many platforms use to alert market participants to available liquidity, have caused concerns among traders about information leakage. Sigma X doesn't send out IOIs, according to Nangalia. "We do some advertising on the post-trade side with some metrics around that," he says. "Our smart router is always totally dark."

One of the problems with anonymous execution is that customers have to rely on the venue to keep out opportunistic traders. A growing number of firms have raised questions about gaming activities in dark pools. "We keep out anyone we can't manage-if we don't like their tactics, they aren't allowed into the pool," explains Nangalia, citing the example of a small quant shop with homegrown, leading-edge algorithms. "We monitor every order that comes into the book. ... All anti-gaming controls are performed through a series of automated tools and analyses that are then backed up by human review of the data to ascertain a bigger-picture view."

While Goldman has been slow to permit liquidity-seeking algorithms to access Sigma X-earlier this year it signed bilateral agreements with Morgan Stanley, UBS and Fidelity Capital Markets-Credit Suisse has taken a very different approach. "We want to trade with anyone with a dark pool or liquidity source as long as the rules of the game are met," says Choe. "We know that some choose to keep their pools closed and want to keep them closed. But we think they're doing a disservice to keep them closed. ... There's a right way to do this, without information leakage-we won't interact with or take orders from those who shop around orders."

Questions have also arisen about how dark pools calculate their volumes. Agency brokerage Rosenblatt Securities and Tabb Group, which both offer volume reports for execution venues, are trying to arrive at a consistent measurement. Matthew Simon, analyst at New York-based Tabb, says the firm asks dark pool operators to help shed light on how they're counting. "We'll ask them what constitutes flow," he says. "We want to see what actually counts because these folks want to be able to tout that they have more volume than their competitors. How volume is benchmarked and portrayed in the marketplace is complicated: Do you aggregate numbers, counting a buy-sell order as one trade or as two?"

"Is it 100 shares or 200 shares-double or single counting," says Goldman's Nangalia. "Counting the trader and the counterparty, as dark pools tend to do? We think there isn't much controversy here. What we print on the tape is what we report."

Sell-side firms such as Credit Suisse and Goldman "get an order and route it out, but did that order touch their order flow?" says Simon. "Does it go to their own internal flow? Would you count it as one-and-a-half? We at Tabb are calling for a universal industry standard-there's a need for an industrywide accord."

Such a measurement could be helpful in an equities market with dozens of dark books, which is too many for the industry to support, says Nangaila. "Once a trader has tried to get a fill in a dark pool but found no liquidity, he or she is unlikely to return," he notes. "Instead of a virtual cycle where liquidity begets liquidity, here we have a vicious cycle where no liquidity begets no liquidity. Once people become skeptical about the amount of liquidity you have in a platform, you will have a tough time."