European Dark Trading: A Question of Clarity

Rebecca Healey | V11:052 | November 2013 | www.tabbgroup.com

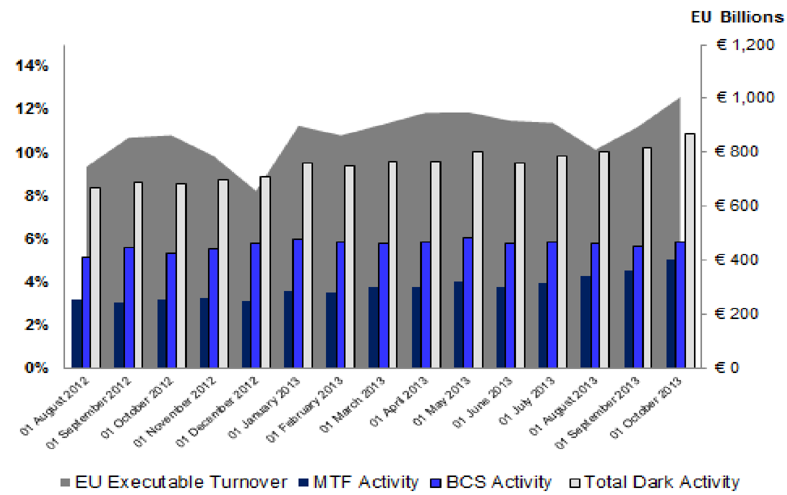
Introduction

Dark trading continues to rise, but headline figures in insolation belie the true picture. As the European trilogue looks to finalise regulation on dark trading, there is widespread confusion in Brussels as to what is the best course of action. Automated dark volumes that include broker crossing systems (BCS) and multilateral trading facility (MTF) venues may be increasing, but proportionately, it is the independent MTF venues that are gaining market share (see exhibit 1). Secondly, the consequences of recent dark pool regulation in Canada illustrate that, despite best endeavours, dark trading has not automatically switched to the lit but has in fact reappeared.[1] So what should European regulators do next?

Market participants remain polarised as to the value of dark venues. Those in favour argue that dark venues reduce slippage costs and are essential to achieving best execution for the underlying investor. According to an independent study by Intelligent Financial Systems (IFS), in August 2013, buy-side order flow received an average price improvement of 12.22 basis points[2] compared to a strategy of sending aggressive orders to the best lit venue.

Opponents claim dark trading is costing investors billions due to damage it inflicts on overall price discovery and market quality.[3] Those that feel dark pools need to be restricted have called on regulators to introduce dramatic changes, including minimum trade size requirements and preferential treatment for lit venues. The more extreme proposals could signal the demise of dark pools entirely.

Exhibit 1
Current European Dark Volumes



Source: Individual Broker Data/ Markit BCS/ Thomson Reuters Equity Market Share Reporter (EMSR)/TABB Group

[1] TABB Group, *Canadian Equity Market Structure: Dark Liquidity*, September 2013
[2] Intelligent Financial Systems, *LiquidMetrix Guide to European Dark Pools*, August 2013
[3] Capital Markets Cooperative Research Centre, Sydney

Dark trading does not equate to over-the-counter (OTC) activity. OTC figures will also include a variety of trade reporting functions, such as beneficial ownership, price adjustments, fund-to-fund crosses, 'broker-to-broker', 'give-up/give-in' activity and so forth. For the purposes of this report, we focus on 'addressable' dark pool liquidity – systematic internalisers, BCSs and MTFs – which currently stand at 11% of European equity turnover year to date. (see exhibit 2).

Exhibit 2
BCS and MTF activity as Addressable Liquidity

Date	Thomson Reutuers EMSR EU Equity Turnover	Total Addressable EU Turnover (Inc BCS)	Combined BCS Total Turnover	BCS % of Addressable EU Turnover	Thomson Reuters EMSR Dark MTF	MTF % of Addressable EU Turnover	Total Dark Turnover	Dark (MTF & BCS) % of Addressable EU Turnover
Aug-12	€ 1,107,501,454,977	€ 787,356,733,518	€ 40,626,846,522	5%	€ 24,886,916,310	3%	€ 65,513,762,832	8%
Sep-12	€ 1,344,659,349,165	€ 905,625,916,694	€ 50,653,250,310	6%	€ 27,280,140,540	3%	€ 77,933,390,850	9%
Oct-12	€ 1,347,873,923,094	€ 912,328,844,290	€ 48,655,367,341	5%	€ 29,174,064,332	3%	€ 77,829,431,674	9%
Nov-12	€ 1,231,398,407,690	€ 832,442,669,556	€ 46,124,812,593	6%	€ 26,660,807,869	3%	€ 72,785,620,462	9%
Dec-12	€ 1,082,781,051,436	€ 697,095,367,233	€ 40,043,133,285	6%	€ 21,833,851,600	3%	€ 61,876,984,885	9%
Jan-13	€ 1,432,135,257,723	€ 955,228,227,203	€ 57,079,300,154	6%	€ 33,746,059,606	4%	€ 90,825,359,760	10%
Feb-13	€ 1,348,439,610,885	€ 916,882,437,516	€ 53,504,637,262	6%	€ 32,232,326,538	4%	€ 85,736,963,800	9%
Mar-13	€ 1,487,022,167,729	€ 959,524,715,123	€ 55,304,107,261	6%	€ 36,245,550,838	4%	€ 91,549,658,099	10%
Apr-13	€ 1,745,251,329,710	€ 1,006,352,933,667	€ 58,773,974,299	6%	€ 37,482,262,665	4%	€ 96,256,236,964	10%
May-13	€ 1,817,023,944,533	€ 1,010,342,748,517	€ 60,788,598,928	6%	€ 40,300,718,917	4%	€ 101,089,317,845	10%
Jun-13	€ 1,411,009,508,304	€ 973,413,791,304	€ 56,198,647,762	6%	€ 36,274,302,162	4%	€ 92,472,949,924	9%
Jul-13	€ 1,358,522,883,820	€ 965,849,737,927	€ 56,276,599,017	6%	€ 38,318,840,127	4%	€ 94,595,439,144	10%
Aug-13	€ 1,155,962,050,749	€ 860,147,510,481	€ 49,520,537,252	6%	€ 36,525,046,796	4%	€ 86,045,584,048	10%
Sep-13	€ 1,321,366,670,809	€ 948,891,813,268	€ 53,701,750,649	6%	€ 43,126,455,667	5%	€ 96,828,206,315	10%
Oct-13	€ 1,472,134,272,696	€ 1,003,384,026,005	€ 62,248,124,448	6%	€ 51,857,378,926	5%	€ 114,105,503,374	11%

Source: Individual brokers/Markit/Thomson Reuters EMSR/ TABB

Regulators want greater transparency over the marketplace, which is right and fair if they are to be able to ensure a robust and well-functioning market. The debate is whether greater regulation of dark pools will deliver this, or whether it will inadvertently create greater opacity. We would argue that rather than impose blanket regulation on all 'dark' trading, regulation would achieve more by 'cleaning up' dark trading, clarifying the rules and restricting activity that offers little real value to institutional investors.

Dark trading in some form has always existed. Historically, institutional asset managers looking to trade in size would turn to their trusted broker to execute trades using risk capital or to find a 'natural block' on the other side. As methods of trading and investment have altered, the rise of passive index trading has diminished the number of natural blocks available. In addition, the inclination to execute using risk pricing has diminished in light of the capital constraints banks now face.

Changing methods in investment and execution are also eroding differences between exchanges, brokers, and the sell side and buy side. As electronic trading reduces the requirement for human interaction, the cost of trading has declined, but so too has the ability to generate revenue for both exchanges and the sell side. The loss of revenue has led the exchanges to search for new willing counterparties – such as high-frequency traders –whose activities may be counterproductive to the revenues of longer-term investors.

BCSs, which generate much of the controversy surrounding dark trading, offer the sell side the ability to net off costs and remain competitive in a shrinking market. Unlike conventional exchanges, where transaction prices and participants are published, BCSs provide a market-making facility where buyers and sellers are matched electronically in anonymity. Brokers then pay a lower fee to the market operator than if the trade was completed on a public market, which enables them to offer reduced cost of trading to the buy side.

The growth of automated dark pools has enabled liquidity to be democratised rather than remain locked in a handful of exclusive bilateral relationships. Yet levels of darkness among the pools themselves vary – there are even some dark pools on exchange. Recent developments at Nasdaq OMX illustrate just how far the decline in revenues generated is altering the rules of the game and ultimately making markets more complex. Proposals to offer high-frequency trading (HFT) clients an anonymous ID they can trade under would appear to be offering preferential treatment to certain clients, at precisely the juncture when the industry should be delivering greater transparency for all.

While the majority of exchanges and MTFs remain non-discriminatory, the buy side demands brokers to differentiate between different types of flow, resting times, counterparties and exposure to other pools. Some brokers may have chosen to obfuscate certain activity historically, which has inevitably added to the controversy. However, for the purposes of this report, all European brokers we spoke to voluntarily provided their BCS data in order to help deliver greater transparency on the issue of dark trading in Europe.

Automated trading has undoubtedly created more efficient markets for retail and institutional investors – spreads have narrowed, commission rates have fallen and market impact has been reduced. However, the cost of trading has focused on explicit costs of execution. As the cost of trading is scrutinised, implicit costs now need to be considered – and that is where some participants believe the quick hit of certain dark trading venues fails.

Execution performance differs according to the venue selected; this is where the regulators should focus their attention if they wish to curtail the volume of European dark trading. The underlying activity of individual pools needs to be understood. While every order will have different execution requirements, this is no longer merely a dark versus lit argument, but a question of how different trading strategies and execution venues should be regulated and fit together for the benefit of all market participants. It is now a question of clarity.

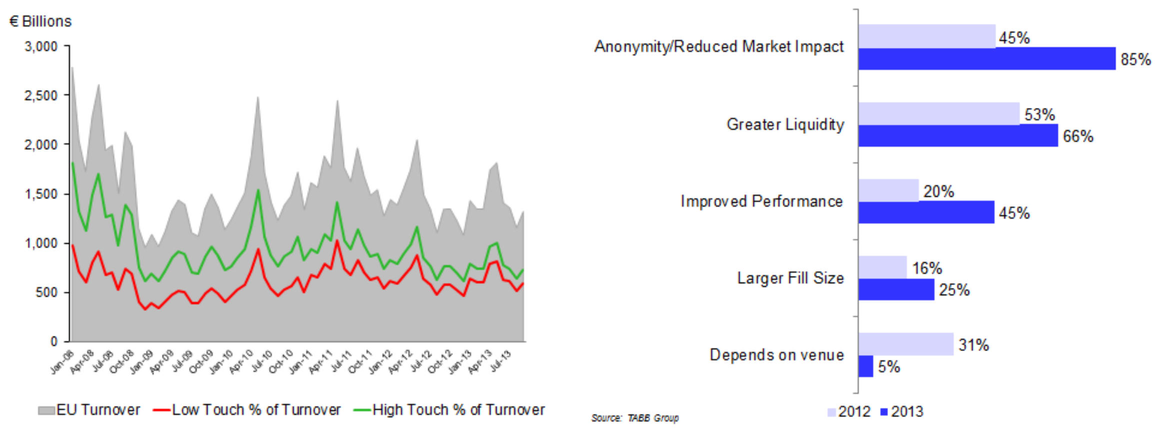
Table of Contents

The View from the Buy Side

Currently, 98% of European institutional investors chose to trade in the dark.[4] The increasing fiduciary responsibility the asset manager is now under to achieve best execution has led to a shift in the balance of power from the sell side to the buy side. Large-in-size orders are no longer automatically handed to a trusted broker, but are increasingly automated and executed in piecemeal order sizes in a bid to limit negative market impact. Generating record fund performance on research is only one stage of the investment process; alpha can very easily be lost through poor execution.

The ability to reduce the signalling of trading intentions has been compounded by the overall decline in turnover (see exhibit 3) – thin volumes expose trading intentions and impact performance as a result. Combine this with a reduction in available traditional brokerage services for the majority of European buy-side participants and it is easy to see why the institutional investor flocks to the dark. The loss of the sales trader to a resource-strained buy side makes the liquidity and price improvement they find in the dark hard to ignore (see exhibit 4).

Exhibits 3 and 4
Rise in Automation/Reasons To Execute in the Dark



Source: Thomson Reuters EMSR/TABB Group

Myth or Fact

The market-wide perception among institutional investors is that their orders may be 'gamed' by other participants in lit markets. This may be true; Europe experiences geographical latencies between trading venues that – combined with the relative speed differences of varying market participants – create the opportunity for such activity to occur.[5] Public venues do attract firms capable of high-frequency activity who will react quickly to available information. However, both exchanges and public MTFs are continually developing anti-gaming technology specifically to address this.

[4] TABB Group, forthcoming *European Equity Trading 2013*
[5] Intelligent Financial Systems, Liquidity Matrix, Briefing - HFT Latency Gaming 2013

The benefit of trading on lit venues is a far greater degree of certainty of execution than any other venue, which becomes decreasingly less likely the purer the dark pool (see exhibit 5). The trade-off is the increase in information leakage. However, the use of more sophisticated, intelligent and intuitive algorithms can mask trading intentions to a degree. By monitoring and controlling micro decisions, such as venue selection and order types, overall performance can be improved on lit venues.

Exhibit 5
The Trade-off between Certainty of Execution and Information Leakage

Type of Trading	Gaming	Methods to Mitigate
Lit	Faster market participants can get ahead "Liquidity" evaporates before trades can be executed	Careful timing of orders. Fast, good technology including TCA Vigilance and trade surveillance
MTF Dark (Chi-Delta, BATS Dark, ITG Posit Turquoise Dark, Nordic@Mid, UBS MTF)	Reference price can be out of synch / manipulated. HFT take advantage. Geography can become an issue	Venue selection. Careful monitoring of resting orders. Minimum order size.
Broker Crossing Systems (BCS)	Less evidence of gaming but potential conflict of interest?	Use available 'levers' Monitor performance.
IOI / Block System (Liquidnet)	Zero Opportunity	Not required

Certainty of Execution

Information Leakage / Gaming Potential

Source: IFS/TABB Group

In reality, there is little incentive to take the risky option of sending an order for a possible match in a dark pool when a lit match at the same price is available. Yet the buy-side belief remains that with even just the possibility of execution, the enhanced performance they are able to achieve in the dark will continue to ensure these venues remain the destination of choice.

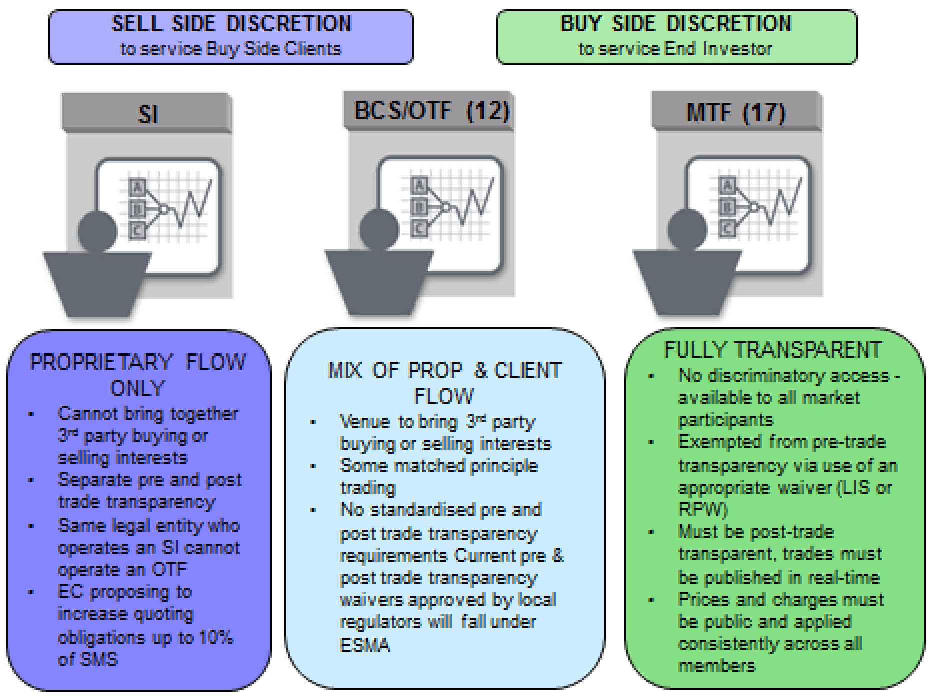
As HFT and automated trading have become more heavily constrained by European regulation[6], the return of the institutional investor has contributed to the increase in dark activity. As regulators look to contain volatile activity and reduce turnover, they are inadvertently creating favourable conditions for dark trading to grow. Without requisite volume in the lit venues in low-volatility markets, institutional investors are forced to turn to dark venues in order to limit information leakage, which can be damaging for wholesale activity.

[6] TABB Group, *European Equity Trends 2013*, January 2013

Differences in the Dark

In order to increase the ability to execute on non-lit venues, the provision of liquidity has to be made more attractive. This is achieved either through improving the quality of liquidity or lowering the costs of trading. Systematic internalisers (SIs) can achieve this by offering risk prices from internal books, while BCSs – as yet unregulated – offer a myriad of options, from risk reduction to strict counterparty controlled venues, through to crossing internal flow in order to reduce external exchange fees (see exhibit 6).

Exhibit 6
Current Automated Dark Options



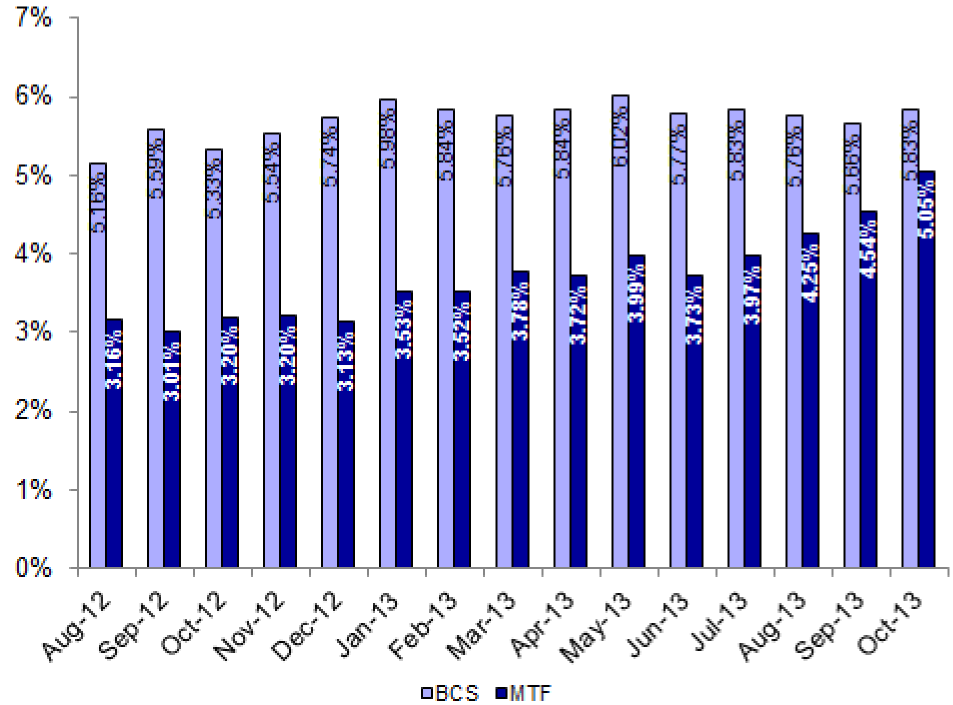
Source: TABB Group

Trades on a BCS are far less correlated with primary market movements, delivering enhanced performance for certain trading strategies. As there is less short-term adverse selection or mean reversion on a BCS, time and volume-weighted strategies will perform better.[7] This is due to the principal advantage of a BCS; the ability to control counterparty access to the pool, as well as what type of flow participants interact with. BCSs can include proprietary trading and market-making business within their volume figures, which MTFs cannot. BCSs also typically accept order flow from broker-supplied trading algorithms. Mixing proprietary flow and client flow provides the buy side with the matches they want, while internal market making can execute without incurring the spread on the open market.

[7] IFS LiquidMetrix Briefing, *Adverse Selection Following Fills*, 2013

And therein lays the dilemma. BCSs that heavily ring-fence the quality of their flow will also, by default, reduce the quantity of their flow and ultimately the success of their dark pool. Attracting greater liquidity inherently means being less selective and less stringent on the type of flow to enter the pool. As the buy side have become more demanding in terms of BCS activity, brokers have been left with little wiggle room but to split their systems to accommodate different order flow from different market participants. As such, most broker crossing systems now have at least two pools within their system, diluting the overall available liquidity for the institutional investor, leading the buy side to move towards dark aggregators in search of liquidity. As volume shifts from BCSs to MTFs, certain broker crossing pools will by default diminish over time, as liquidity begets liquidity (see exhibit 7).

Exhibit 7
MTF versus BCS Market Share (August 2012 – October 2013)



Source: Individual brokers/Markit/Thomson Reuters EMSR/ TABB

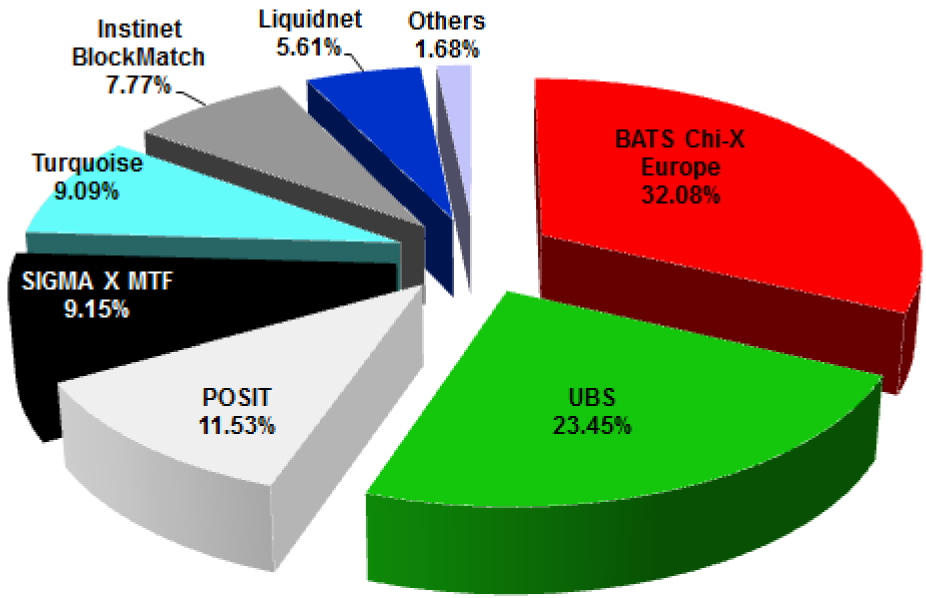
The Growth of the MTF

Within the MTFs, there are three further categories:

- Open MTF dark pools: Chi-Delta, BATS Dark, Turquoise Dark, Nordic@Mid, UBS MTF;
- Agency broker/independent dark pools: BlockMatch, ITG POSIT, Liquidnet;
- Those that offer the buy side the ability to negotiate and cross larger blocks, such as Liquidnet.

Currently, nearly 99% of orders sent to MTFs are conducted on just seven venues with more than three-quarters of activity on just four venues (see exhibit 8). The economics of maintaining an MTF in the current economic climate are not favourable, so further consolidation is likely over time. Independent or agency dark pools have been outperforming of late, which in fact illustrates the success of MiFID I in delivering fair competition among trading venues. The lack of conflict of interest enables these venues to focus solely on offering best execution for the benefit of the underlying investor.

Exhibit 8
Growing Concentration of Dark MTF Flow



Source: Thomson Reuters EMSR / TABB Group

Historically, dark pools matched orders using the primary market mid-price. This was a market standard seen as fair given that the primary (national) market accounted for the majority of trading volumes. However, while this theory works for large liquid names, recent research has shown that the European best bid and offer (EBBO) mid-prices can be manipulated fairly easily by faster market participants posting inside the primary best bid/offer (BBO), then executing on the EBBO mid to their own advantage, then cancelling the original order on the primary exchange.[8]

Market participants are already adapting to provide workable solutions without regulation being imposed. New industry initiatives are emerging, such as Instinet's BlockMatch, which now offers EBBO mid-matches so there is less opportunity for direct arbitrage. Turquoise Uncross™ also offers a new smart 'periodic' matching that will prevent passive

[8] IFS LiquidMetrix, *Bid Offer Dark Pools – a Free Lunch?* February 2013

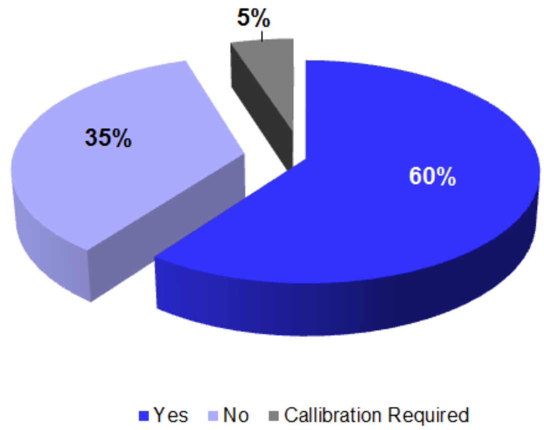
buy-side order flow from being disadvantaged. The ability to offer continuous midpoint matching where, with no pre-trade display, both buyers and sellers can rest passive orders that may match at a random uncrossing period will contribute to quality and fairness for both sides.

Moving from the Mid to the Touch

In the battle for liquidity, some MTF venues have begun to offer the option of matching orders based on the primary or EBBO touch prices rather than the mid. The benefits for the passive order is rather than splitting the spread with the aggressive side of the trade, those who are prepared to wait can capture the full spread as compensation for providing liquidity. Therefore, market participants are able to obtain the same benefits as providing liquidity on a lit venue but without needing to disclose the size of the full order, offering greater protection from market impact.

While the argument for this development appears fair, it is muddying the waters in terms of the reasons for entering a dark pool. Institutional investors were polarised on this issue back in the summer, highlighting the different requirements according to the type of order flow being executed. Unfortunately, it would appear we have now reached the juncture where dark pools can no longer be a variety pick and mix but will require clarification and, in some cases, a reduction in offerings in order to deliver market standardisation and simplification. As such, market participants are moving towards an acceptance that crossing at mid will be the norm for dark pools in the future (see exhibit 9).

Exhibit 9
Should Dark Trading be Limited to Midpoint Execution Only?



Source: TABB Group

Pure Dark

Dark pools that offer the spread are likely to encourage greater liquidity to be provided and are therefore more likely to offer a better overall probability of getting **a** match. But in terms of market impact, the pure midpoint pool remains the outright winner, ensuring both sides of each trade receive a fair reference price for all their matched trades as well as being as uncorrelated as possible with primary market mid-price movements.

Trades that occur at a price which fairly divides the EBBO market spread between the aggressive and resting sides of the trade ensure that even when prices are moving, fast participants are prevented from taking preferential prices based on the current mid which may not fully reflect a short term market movement. Trading at the mid enables both parties (buyer/seller) to limit information leakage, reduce any impact on price formation, thereby having zero directional impact on overall market activity.

If an execution in a dark pool is preferable to a similar execution on a lit venue – as it will lower costs, reduce market impact and offer potential price improvement – it would seem that continued growth in the dark is a certainty. What would be of greater benefit would be to get dark trading back to its original purpose: assisting institutional investors with wholesale order flow, whether in one parent block or in child-order activity. Only greater clarity over what is occurring where will put market participants back on a level playing field.

The Right Regulation

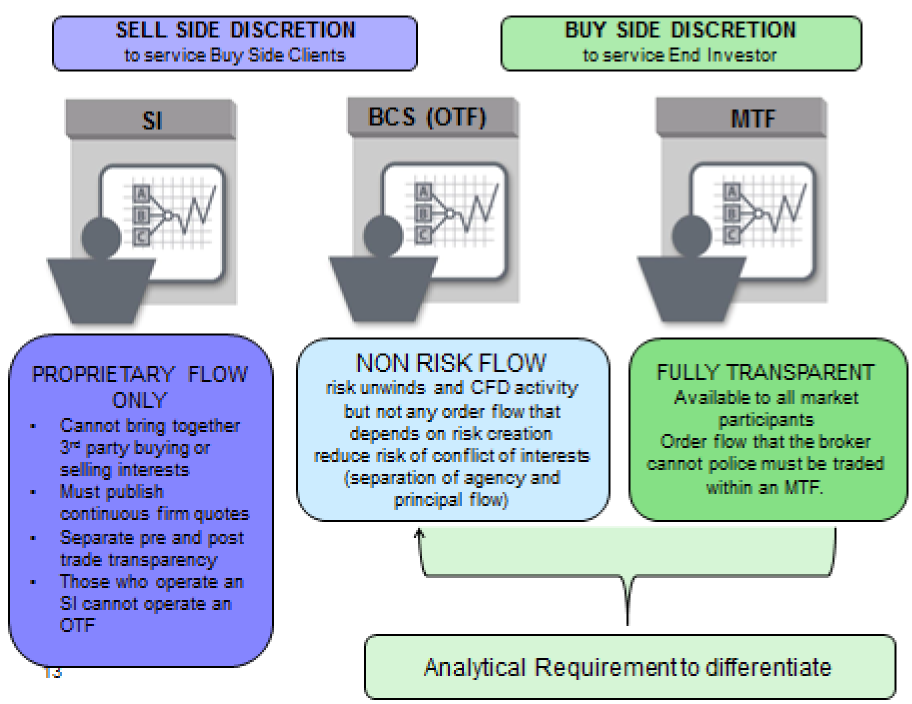
Clear, simple guidelines, such as the threshold block rule in the US (10,000 shares or $200,000), together with the ability for the European Securities and Markets Authority to adjust any proposed thresholds in consultation with the marketplace, are the most efficient methods to restrict unnecessary dark trading, according to the buy side. This could be achieved without having significant negative impact on both pension funds and SME activity.

Cumbersome regulation, such as the proposed volume cap or minimum-order sizes at very prescriptive levels, will only serve to deliver a new level of complexity and inconsistency, which would further reduce confidence in the market, as well as create new challenges for regulators to monitor and surveil.

To OTF or Not

The retention of the equity organised trading facility (OTF) category with clear boundaries could limit activity and reach (see exhibit 10), whereas its demise is likely to force BCSs to morph into both SIs and MTFs, which would further add to the complexity and opacity of European equity markets. This could potentially double the current number of venues as BCSs have to be replaced by SIs and MTFs in order to cater for different client activity.

Exhibit 10
Eliminating the Equity OTF

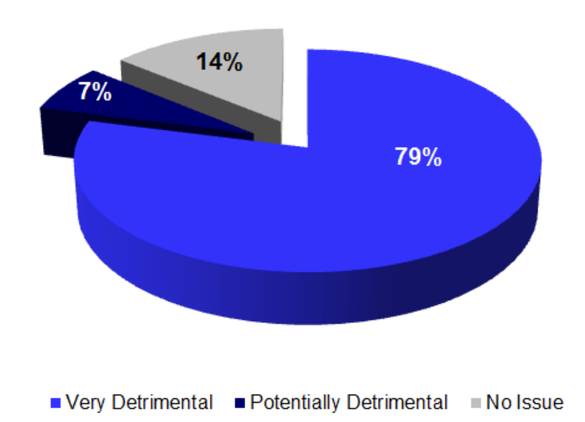


Source: TABB Group

While the reintroduction of the equity OTF category by the European Commission recognised that brokers have an important role in matching investor' trades in circumstances where there is increased market risk, the continued ban on OTF-operator deployment of own capital, together with the loss of matched-principal trading, will negatively impact on equity trading in second and third line names, making the advantage of the equity OTF category fairly redundant. If there is no simultaneous, equal and opposing trade to match any client order, investment firms will need to take on their clients' positions against their own risk book until either an opposing client order is found or the position can be unwound against multiple other orders within the OTF or another trading venue.

The latest proposals to restrict dark trading at 4 and 8% have the potential to inadvertently create greater opacity as well as seriously impact institutional investors ability to execute order flow. Only 14% of institutional investors do not have concerns regarding the introduction of the volume cap proposals (see exhibit 11). The vast majority anticipate the impact will be severe, forcing them to return to more traditional forms of execution.

Exhibit 11
Do you have concerns regarding the introduction of Volume Caps on Dark Pools?



The Commission on the other hand perceive that the introduction of this regulation will not lead to a disruption of trading despite the fact that if an individual cap in an instrument is breached, the national competent authority which authorises the use of this waiver will be obliged to suspend it for a period of 6 months.

The second area of regulation has focussed on the subject of waivers. Buy-side institutions claim they rely on pre-trade transparency waivers to reduce trading costs and increase investment returns. Yet there is a trade-off. Opaque markets serve no-one; at best order flow becomes harder to execute, and at worst, inappropriate activity is masked. If regulators are concerned, exemption from pre-trade transparency could be restricted to those providing a value to long-term investors, namely European pension funds, above and beyond what is available on a displayed market. This could be achieved by focusing on two key areas.

Pre-trade for Large in Scale

The proposal that there should be minimum dark sizes must allow firstly for calibration of what can be considered large in size. By developing market-specific benchmarks rather than blanket legislation, the accuracy of price formation can be better assessed and more effective decisions can be made pre-trade. In particular, a recalibration of the large-in-scale waiver to more practical levels based on average daily volumes (ADV) traded or nominal market size (NMS) would benefit institutional trading.

Secondly, 'large in size' should be made applicable for the full order, including order 'stubs'. If the order size is 1 million Vodafone and 500/- are executed, the balance of the order will fall outside the large-in-scale waiver. There are certain strategies, such as those that spread trading out over a single day to achieve an average price, that require the use of small trades in the dark. The small crosses (child orders) can roll up to be part of the larger (parent) order. As execution responsibility shifts from the sell side to the buy side, this type of execution behaviour is likely to increase. Appropriate order flagging to allow traceability of child orders up to a larger parent would distinguish those orders that justifiably should be allowed to trade in the dark. New initiatives are currently under discussion with market participants spearheaded by the UK-based Investment Management Association.

Maintaining the Reference Price Waiver

The reference price waiver (RPW) protects wholesale trades against market impact, providing efficiency and accessibility for investors in the execution of their orders. The RPW, if restricted to trading at the midpoint, provides price improvement. There is an argument that the use of the midpoint only provides an incentive to trade in the dark. However, without the ability to trade through the spread, there would be less flexibility within a dark venue to execute, thereby encouraging traders to return to the venue where they have greatest certainty of execution – the lit. Trades based on the RPW executed at the midpoint will only ensure value is provided to long-term investors – in the form of material price improvement – without having any significant or adverse impact on price formation.

Since MiFID I, recent data for European markets suggests that dark MTFs (the majority of which use the RPW) traded just 4.5% of overall turnover in European equities in 2013. Therefore, restricting the RPW is unlikely to shift significant volume to the lit markets. Instead, it is more likely to reduce the willingness of investors to trade, increase transaction costs and materially reduce aggregate volumes of trading, thus limiting liquidity

Capping activity at the midpoint based on the RPW would offer clear price improvement and ensure dark pools returned to their original purpose. This would also clear up increasing concerns regarding the significant growth of touch trading. Venues trading at the midpoint represented a low of 1.99% of overall market volume during December 2012, versus a previous high of only 2.33% of overall market volume in August 2012.[9]

From Canada to Italy

The basis for increased regulation is that this will shift those trades previously executed in the dark to the lit, thereby enabling investors to detect a credible price signal, however the evidence so far would prove the reality is likely to be different. In Italy the clamp-down on OTC trading pushed flow back on the primary market. However an increased proportion was traded bilaterally and only reported on-exchange. While initially there was a 20% increase in trades on the primary exchange, the volume of continuous activity

[9] Liquidnet, *Views on MiFIR (Article 4) – Granting of Waivers*, 2013

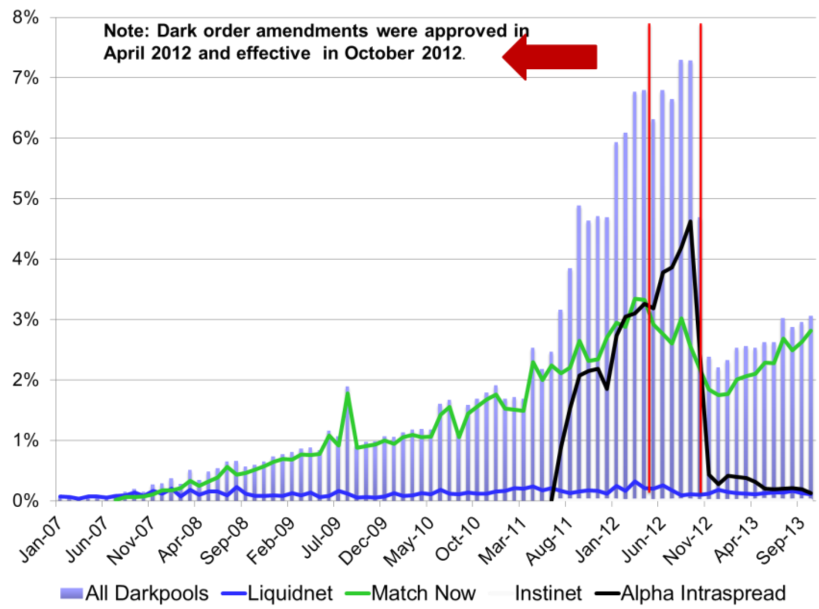
in the lit market overall has declined. Similarly while there was an initial reprieve in orders traded OTC and reported to BOAT, this too has now reversed[10].

To limit the execution of small orders, Canadian regulators made amendments to the definition of dark orders under the Universal Market Integrity Rules (UMIR). The reasoning behind this appears to be that small, dark orders impaired price discovery and unfairly limited interaction for displayed orders.[11]

The UMIR amendments limit dark order interaction to be either (a) at a "better price" (price improved at least one trading increment or midpoint) or (b) an order of more than 50 standard trading units or having a value of more than C$100,000. The revised definition of "dark order" was designed to provide smaller active (that is, retail) orders the opportunity to receive "meaningful price improvement" and protect small displayed passive orders (although passively displayed orders most often represent high-frequency orders, rather than retail orders).

The outcome proved to be somewhat different. The implementation of the order amendments led to an initial significant drop in volumes and initially left retail orders incurring higher fees on lit venues. However subsequent activity has returned to MatchNow, illustrating that market participants find value in trading in the dark and will continue to gravitate towards those venues that are able to provide dark liquidity (see exhibit 12)

Exhibit 12
Return of Dark Activity in Canada post regulation



SOURCE: TABB Group, IIROC, Thomson Reuters

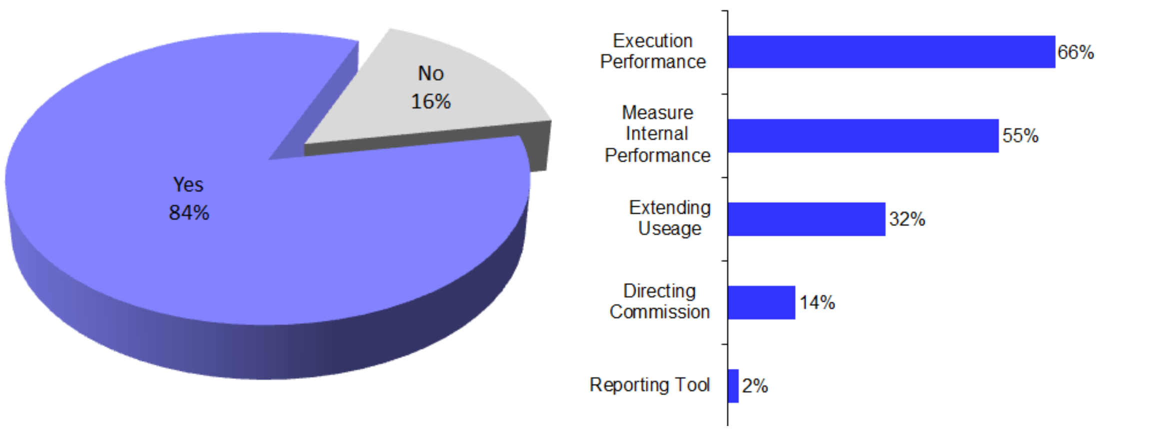
[10] European Equity Trends – Mid Year Review 2013, TABB Group
[11] TABB Group, *Canadian Equity Market Structure: Dark Liquidity*

Data Education

The main argument against dark pools is that they damage price discovery – yet institutional market participants do not perceive this to be the case. The only way to establish the truth is by increased use of independent data analysis within a standardised framework.

Mandated under MiFID I, greater responsibility was placed on the asset manager to deliver best execution to their underlying client. It is only with the use of greater automation and standardised measurements, such as Financial Information eXchange (FIX) Protocol tags, which will provide the correct level of post-trade analysis to deliver effective pre-trade transparency. As such, there has been a significant increase in the use of data analysis by institutional asset managers to ensure they meet their fiduciary responsibility of best execution (see exhibits 13 and 14)

Exhibit 13 and 14
Increased Use of TCA /Reasons for Using TCA



Source: TABB Group

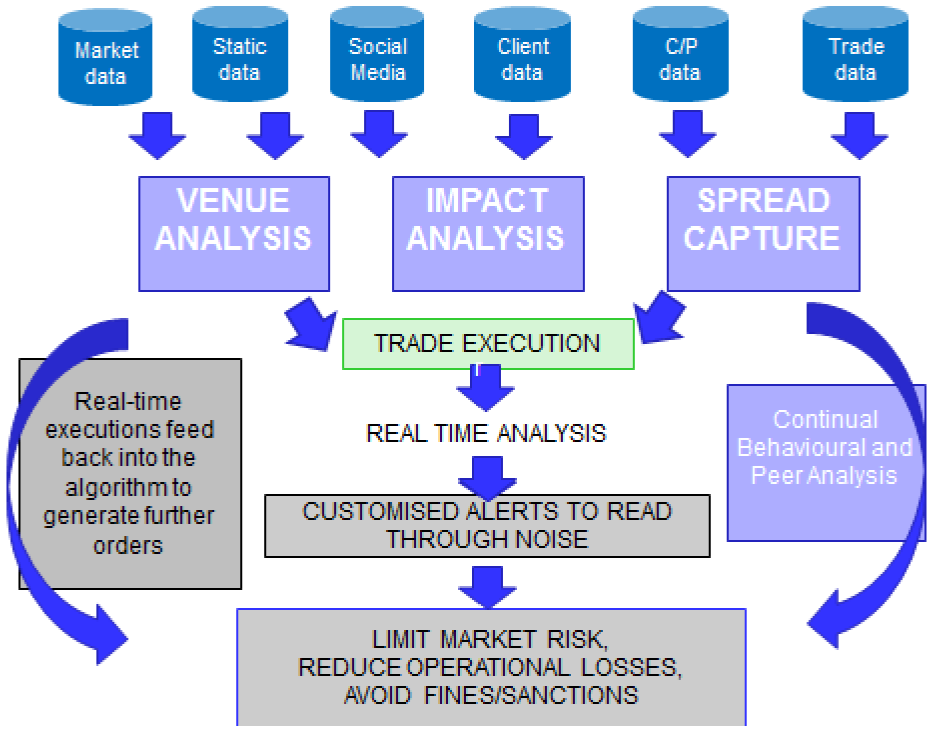
Yet any analysis must also be placed into context. Understanding that the quality of execution data can be skewed by the fact that the earliest and easiest executions occur off exchange – and by the time executions occur on the lit market, the information has leaked – will ensure effective use of both dark and lit venues at the appropriate juncture for the benefit of underlying investors, such as pension funds.

As market participants are increasingly able to piece together a more detailed picture as to the toxicity of both activity and venue, fund performance will ultimately benefit. Previous poor analysis of some dark pools has now been attributed to incorrect usage of a particular pool, rather than the venue itself. Buy-side traders are using true-cost accounting (TCA) to understand their own performance, as well as monitoring the performance of the underlying broker or the venue.

The Future Ahead

Using post-trade statistical analysis to measure toxic activity in a dark pool is still suboptimal. Mean reversion analysis takes a time and price stamp for each instance that an order interacted with a dark pool and then looks at the price at different time intervals to see if a statistically significant pattern of price behaviour emerges. While this analysis can provide valuable information, the damage has already been done, and it assumes that the situation will remain static. Preventative, real-time analysis and liquidity profiling will enable market participants to combine the benefits of thorough post-trade mean reversion analysis with effective predictive models as markets move (see exhibit 15).

Exhibit 15
The Future Value of TCA



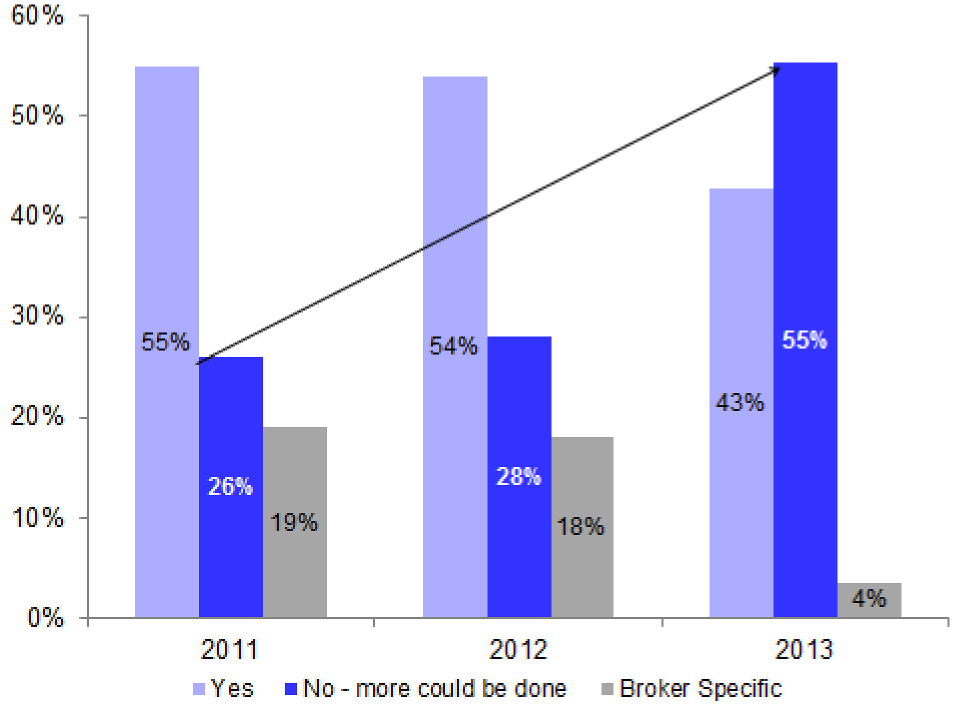
Source: TABB Group

Simplification of market structure will ensure clarity of the rules and should include standardisation of client facilitation of order flow, restrictive onward routing and the minimal number of order types.

Greater simplification will divorce fact from fiction and the buy side believe that more could be done to improve this. As buy-side firms invest in greater analytic technology, the requirement for improved data grows. Transparency may be improving but there is inconsistency in TAG codes and data that requires sufficient cleaning before any meaningful conclusions can be drawn (see exhibit 15).

While the buy side is increasingly requesting greater detail in FIX messages for automated orders, there is little or no data available for those trades executed via phone orders in dark venues. Looking ahead, the same level of transparency for phone/voice business as for automated/algorithmic trading will also need to be mandated.

Exhibit 16
Is There Sufficient Post Trade Transparency in BCS?



Source: TABB Group

New initiatives, such as BXTR by BATS Chi-X Europe, which offers market participants the ability to report OTC trades via Market Model Typology (MMT), will improve standardisation and increase transparency. With a focus on prevention rather than cure, improved data standards will not only provide increased transparency within the dark but also ensure robust monitoring and more effective supervision in the process.

Conclusion: Finding a Solution

Canadian dark volumes are now back at 3%. Italy's dark decline has now reversed. What should regulators do? Haunted by the mythical figure of 40%, dark trading remains ostracised. However, failure to understand the true level of dark trading activity and that OTC activity does not equate to executable dark activity risks imposing unworkable regulation, as well as impacting innocent bystanders unnecessarily – namely pension funds and SMEs.

The current quality of lit venues, the economic environment and growing fiduciary responsibilities to deliver best execution continues to ensure the buy side remains willing participants in the dark. Proposed legislation will not automatically return trading to the lit. However, greater understanding of what happens when order flow is traded on any particular venue – dark or lit – thereby ensuring buy-side traders have full control of their implicit as well as explicit trading costs, will be critical to improve confidence in current European market structure.

There is market speculation that the increase in dark activity is predominantly based on touch activity rather than at the traditional midpoint. Unfortunately, without mandated reporting, all this will simply remain speculation. Until a system of mandated reporting exists based on FPL FIX Tags or MMT typology, there is no incentive for all participants to detail all activity in the dark. Some may choose to be fully transparent with individual clients but this is based on preferential treatment rather than an industry standard.

The ability to measure performance and prevent the potential toxicity of certain dark pools will be far more valuable in the longer term. Ultimately the buy side will vote with their feet, and the ability to correctly analyse individual venue performance will determine where institutional investors choose to trade – provided dark pools are not regulated out of existence in the meantime.

We have reached the nadir. Either the industry opens up and allows greater transparency in the dark or we will end up being forced to trade by alternate means. We risk creating greater opacity through inadvertent negligence.

However, a conciliatory tone is required. We are unlikely to find a solution that will be satisfactory for everyone. From buy side to sell side, exchanges to vendors, market participants are beginning to establish industry solutions as the buy side exerts more control over what happens to their order flow and the trading counterparties they choose to engage with. Anti-gaming and opt-out functions, currently the prerequisite for broker dark pools, also require the buy side to step up and educate themselves.

As execution becomes further divorced from the research process, proving best execution has been delivered will be critical. Full disclosure of execution, dark or lit, will become mandatory. Now is the time for dark trading to come clean: it is a question of clarity.

About

TABB Group

TABB Group is a financial markets research and strategic advisory firm focused exclusively on capital markets. Founded in 2003 and based on the methodology of *first-person knowledge*, TABB Group analyses and quantifies the investing value chain from the fiduciary, investment manager, broker, exchange and custodian. Our goal is to help senior business leaders gain a truer understanding of financial markets issues and trends so they can grow their business. TABB Group members are regularly cited in the press and speak at industry conferences. For more information about TABB Group, visit www.tabbgroup.com.

The Author

Rebecca Healey

Rebecca joined TABB Group in March 2011, bringing more than 15 years' experience in e-trading and financial services. Rebecca has held various sales and trading positions with Bankers Trust, Goldman Sachs, and most recently Credit Suisse, where as Vice President she was instrumental in launching the successful AES (Advanced Execution Services) product to hedge funds from its inception in 2002 until 2008. Prior to this, she was the first electronic trader at Credit Suisse to be registered for all electronic European cash equity markets and covered sales trading into Asia and then Europe between 1997 and 2000. More recently, Rebecca was based in the Middle East from 2008 to 2010. There she was employed by the British Embassy in Bahrain, where she successfully launched the UK Government's financial services strategy and set up the Bahrain Financial Services Roundtable, which remains a key source of information for the UK Government today, especially in relation to Islamic finance. Rebecca holds a Bachelor of Arts degree in Spanish & Latin American History & Politics from the University of London. At TABB Group, Rebecca has authored *Dark Matters; European Equity Trends: 2013 Mid-Year Review; One Touch, One World: The Future of Investment Banking; OTC Equity Derivatives: Harnessing the Liquidity; European Equity Trends 2012/13; European Equity Trading 2012/13: Changing the Rules of Engagement; FX in Transition: Taking The Quantum Leap; MiFID II and Fixed-Income Price Transparency: Panacea or Problem?; Market Surveillance in Europe: Under Starter's Orders; European Equity Trading 2011/12: Looking for Allies in the Face of Adversity; European Algorithms: The Evolution; and Trading in the Middle East: the Road to Mecca.*

www.tabbgroup.com

Westborough, MA
+1.508.836.2031

New York
+1.646.722.7800

London
+44.(0)203.207.9027