Dark Pools – Increasing market depth or liquidity sinkhole?

These evocatively named phenomena of the capital markets have been around a few years. Initially they were dangerous for unwary investors who stumbled into them, but now they are proving dangerous in a different way for those that have hitherto profited from their murky depths.

A dark pool is a private forum for trading securities that is not openly available to the public. The bulk of dark pool trades represent large trades by financial institutions, such as hedge funds, that are offered away from the conventional equity markets like the NYSE, TSX, LSE, ASX, Tokyo Stock Exchange or the NASDAQ, so that such trades remain confidential and outside the purview of the general investing public. The impetus for their evolution was the fragmentation of financial trading venues and electronic trading over the last few years combined with a more liberal approach by regulators powered by the view that “big boys” can look after themselves if they head *off-piste* in their trading arrangements. The principal advantage for institutional investors is that it allows them to transact large blocks of equities without showing their hand to others and thus avoiding market impact as neither the size of the trade nor the identity are revealed until the trade is filled.

This is of course an attitude that is investor-centric and pays little or no heed to the desires or needs of the quoted company (and investor small-fry). Those without access to dark pools are disadvantaged as they cannot see the trades before they are executed; prices are agreed upon by participants in the dark pools, so the market becomes no longer transparent. Smaller investors (and listed companies) think, when they look at market data, that they are looking out the windscreen… but are actually getting a glimpse via the rear-view mirror of a rapid-receding market snapshot.

The dark pools are normally accessed through crossing networks or directly among market participants via private contractual arrangements. Dark pools can be classified into three major types:

1. broker-owned dark pool where clients of the broker interact, most commonly with other clients of the broker (possibly including its own proprietary traders) in conditions of anonymity
2. public exchange-created dark pools to allow their clients the benefits of anonymity and non-display of orders while offering an exchange infrastructure
3. independent companies set up to offer a unique differentiated basis for trading

Possibly the most insidious of the three is the exchange-operated model for it is essentially turning the existing public market into a second-class market, where smaller investors are left to wallow in relative illiquidity while listed corporates find their stock as fair game in the piranha pond of the dark pool with no come back.

The trend has even spurred its own arcane vocabulary. Depending on the precise way in which a “dark” pool operates and interacts with other venues it may be considered, and indeed referred to by some vendors as a “grey” pool. And then the “lit” market is that part of the trading world that is NOT in the dark pool.

The curtain was pulled back, for the general investing public, on this phenomenon with the publication of the book “Flash Boys” by Michael Lewis. The author was famous for his chronicling of the excesses of the M&A boom of the 1980s with Liar’s Poker and Moneyball being his previous exposes of shenanigans in high (financial) places.

Separating Concepts

In the minds of the public – Dark Pools and High-Frequency Trading (HFT) have merged into one evil threatening the markets. However while the activities frequently occur together they are different things.

HFT does not necessarily take place only in dark pools. It also happens on public exchanges in the general mix of trading and makes up a significant (maybe even a majority) of trades on some markets. Some estimates put the amount of ASX volume driven by HFT at 30% of the total turnover. High-frequency trading, with computer programs issuing and either withdrawing or completing huge numbers of orders for small lines of stocks, provides some competition by breaking large lines of stock into small trades that could be executed without significantly moving the price. Therefore HFT can, in some ways, be the opposite of dark pool trading.

One of the complaints about HFT is that it can swamp the markets and their trading systems with a tidal wave of small orders, whereas dark pools are big block trades. By its very nature the HFT market needs small action because blocks are the chunks of stock that gum up the bowels of the market whereas HFT trades might well be seen as the "bran" that keeps everything moving on its way. A bit graphic but you will certainly get my drift.

Ironically some institutions have justified their use of dark pools claiming they have been driven there so they can transact without fear of their orders being picked off.

Flash-crashes

HFT also has a much longer history under its old guise as the "program trade" (computer generated buy/sell orders) which some held to blame for the Crash of 1987. HFT is just program trading on steroids and vastly multiplied in volume. Its bad name for the hoi polloi is due to its role in the increasingly frequent flash crashes which have taken down whole markets for minutes.. or taken down sectors or portfolios for minutes or longer or solely effected individual stocks.

I was formerly with Knight Capital Markets (the world's largest market-maker) where I started up their mining practice. The firm dealt in billions of shares an hour and was a prime mover and shaker in the HFT space. However in July 2012 (after I had left) the firm came to grief when its trading systems went haywire for less than an hour and lost the firm hundreds of millions of dollars, precipitating its loss of independence as an individual firm. It could have been a lot worse though with the firm going bust and ceasing to trade the market would have been left without the medium through which genuine trades are dealt as well as the somewhat artificial or "unnecessary" action of the HFT traders.

We have heard miners complaining that they are the victims of HFT machinations. Interestingly it is the ones who would have good liquidity anyway who raise this complaint. Paradoxically, many junior miners trapped in a liquidity backwater would love nothing more than to see a massive upturn in interest in their stock. Post 2008 one of the main problems that junior miners have had is large "stale" (sour?) holders stuck in their name representing an overhang with no means to exit. Frankly some HFT might clear the decks of stale block holders and make for a new base to move on.

Australia – Draining the Pools?

When I worked for Australia's largest broking firm, Ord Minnett, in the 1980s the rules on crossings were very strict with all blocks having to be shown to the market at the opening of the day even if the broker had a buyer already lined up to take the whole block. By early 2013 the onset of dark pools meant that ASX brokers using their own dark pools had exploded to more than 10% of all trades as they sought to avoid ASX trading fees and keep a bigger portion of a dwindling pie by matching small and even proprietary trades through their own crossing “engines”.

Rule changes were brought in by the ASIC (the Australian Securities & Investment Commission) in May 2013 to try and restore order to this chaos and liquidity leakage. The result was a collapse in volumes moving through dark pools, according to a report in the newspaper, The Australian in October 2013. It quoted figures from financial data provider IRESS and the ASX showing that traditional “upstairs” or block trading venues increased their share by a fifth to 16.2% in the five months after regulations designed to drive trading activity back to the public market were introduced. Much of their gain came at the expense of broker-operated dark pools whose market share shrank from 11.1% to just 4.5%.

That said the focus is again investor-centric and with no consideration for the listed companies. The reason I felt inspired to write this piece was exactly because of gripes by a leading mid-cap miner of our acquaintance that feels its share price on the ASX is not being served by a daily swamping in HFT generated action combined with machinations of the denizens of the dark pools.

Conclusion

Mining share volumes have been low for years now but a reactivation in the sector should also bring into focus the activities of dark pools and HFT movers and shakers. Brace yourself for a rising tide of complaints.

It’s said that nature abhors a vacuum and the appearance of dark pools and its ugly sister, HFT, might be seen as the markets in their ever-inventive way moving in to fill and supply a market niche. However, it might also be interpreted that their appearance is a certain sign of desperation amongst hedge funds trying to extend their lifespans when their old tricks no longer work anymore. Hedge funds have had a 30-year roll and like other investment vehicles before them they must reinvent themselves or suffer obsolescence.

HFT though may be the last gasp. In making markets “efficient” and highly liquid it removes the rationale of the hedge funds in ferreting out anomalies in the markets. Thus HFT does not faze me much, excepting a circumstance where a flash-crash coincides with a real world event (e.g terrorist attack). This scenario has not been stress-tested in a real life situation yet.

Dark Pools though are concerning. Instead of helping liquidity they are fragmenting the market place and making it hard to match trades in the old “many-to-few” mode. A crossings market is all very well and good for institutions but it implies that a big chunk of liquidity removed I the past (when the stake was initially bought) largely stays sidelined by just being crossed intact to another party. It’s like a game of pass the parcel but just a bigger parcel. Only heavyweights can lift or carry such a load. So while HFT may be making markets as close to perfect as they can get, the dark pool phenomenon is taking us back to the days when brokers matched trades in coffee houses or under a buttonwood tree.