Navigating dark & clear liquidity pools

Greater choice on where to trade is becoming a reality in Europe following MiFID. Are these new pools full of sharks or dolphins?

The timing of the GL NET FORUM conference on how to navigate through dark and clear liquidity pools could not have been better. And when the moderator David Myers, a partner at Deloitte, stated that he was going to oversee a great panel consisting of, "the top dogs from the new players," he was not wrong.

"We have got bank consortiums coming together and launching. We have got exchanges introducing and possibly cannibalising their own business, by introducing multi-lateral trading facilities (MTFs)," said Myers. And as he set the agenda, Myers predicted competition between the new MTFs, as well as with the incumbent exchanges, would remain fierce.

Chi-X was the first pan-European MTF to launch. Hirander Misra, its chief operating officer, said that during the 18 months it has been running, it has regularly attracted €4 to €7 billion of business a day across a range of major pan-European names. Not surprisingly, Misra said it was proving very popular.

"In August, for example, in terms of price improvement alone on the platform across the names that we trade in comparison to the primary exchanges, you were saving in the region of €1 million per day. That figure has been even more in September with the higher trading volumes," he said.

However, Eli Lederman, chief executive of Turquoise, the multi-bank owned MTF, argued that the dark liquidity pools and block crossing systems set up in Europe to date have not yet materially attracted adequate volume or market share. Furthermore, Lederman stated that there is more to trading than sheer speed and facilitating algorithmic trading programmes. He claimed Turquoise caters for all of these needs, while recognizing the importance of visible order books that can access institutional size and liquidity in an integrated market model platform.

Despite the relatively limited take up of dark pool trading so far, the panel debated whether the arrival of players such as NYFIX Euro Millennium, mean

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that the concept is finally set to take off in Europe like it has in the US?

"We are six months into operation in Europe. We are starting to attract significant amounts of liquidity from a mixture of buy-side and sell-side firms. They are all looking for natural block crossing opportunities," said Chris Smith, head of business development and a director at NYFIX.

According to Smith, greater plurality in order flow execution and execution strategies is inevitable and will lead to new electronic crossing networks (ECNs) or MTFs. That means the exchanges will have to innovate to attract or even keep that proportion of clients' liquidity they currently enjoy purely down to their status as incumbents, because players such as NYFIX will be offering pricing efficiencies and reduced market impact as part of their value proposition.

This bodes well for NASDAQ OMX, which was launching its platform the morning after the GL TRADE conference. Its president, Charlotte Crosswell, said the platform's matching engine is superfast, promising latency of just 250 microseconds. It also connects to other venues if they have a better price or deeper liquidity.

"Then we have the routing engine, so a firm that wants to put an order into us, we can take the best execution, we can see what the best price is across the whole of Europe, including some of the MTFs – (we are) connecting to Chi-X and Turquoise on day one – and take that best price," said Crosswell.

Naturally, NASDAQ OMX will try to dive into the liquidity on its own order book first before going out to other markets. But it offers functionality to allow brokers to select on what MTF – and in the near future – what exchange they want execution on.

An adjunct to these players is Equiduct Trading. Artur Fischer, its CEO, said it has unique features which makes it different and not a direct competitor to many of the other new players in the market.

"The real innovation we give you is what we call 'PartnerEx'. This provides the capability to create a B-to-B relationship, thus customising relationships with counterparties. This includes guaranteeing best execution, but also complete flexibility on clearing and settlement environment," said Fischer.

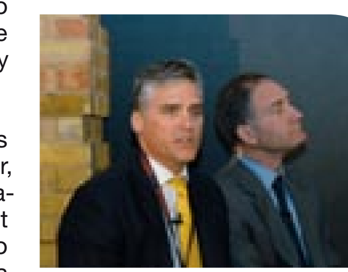
More speed less haste?

"A couple of you have mentioned speed. When does it end? How fast is fast enough?' asked Myers. [It] seems to be the front-running statement made by everybody – 'I have got the fastest car in town and I have painted some new go faster stripes on it just yesterday!'" he cheekily suggested.

"Every data centre in the United States and Europe is crammed to the gills with racks of servers and air conditioners to keep them cool. At some point people have to take a step back, look at the market, look at the market structure, and say, 'Is this rational?'" agreed Lederman.

There are issues surrounding external latency and the risk factors that those entail are crucial to considerations around speed. Furthermore, there are serious restraints on the speed of market data depending on what exchange customers are using.

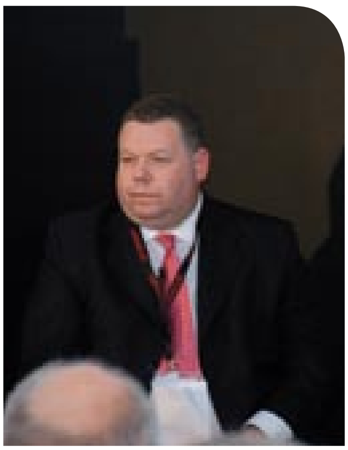
"I would like to point out is that there is a price you pay if you go down to the microsecond game, and the price you pay at some stage might be resilience. If things don't go well you end up in a huge disaster," said Fischer,



referring to when the London Stock Exchange (LSE) was closed virtually for a whole working day in September.

Myers suggested that one issue that incident brought home is the market's need for a consolidated tape. The LSE was shut due to its technical difficulties but it was the lack of a proper reference price that hindered market activity on the various MTFs that were up and running. Clearly the exchanges will be resistant to such a move, given the revenues they generate from market data.

"We need to have a price reference," said Pierre Gatignol, executive chairman of GL TRADE. "In the US we have a real balanced process of smart routing – they somehow don't care what the point price reference is." He added that with time, as brokers put in place the capacity to take advantage of all the new comers in the MTF and ECN space, a big outage on an exchange will see liquidity shift quickly to other venues. But at the moment, most dealers' trading programmes did not account for the possibility that there would not be a primary exchange. It is unlikely that the market would cease to operate if something similar happens again.



Eli Lederman, chief executive at Turquoise:
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Will investors dip into the dark pool?

The new players believe that the impetus for them growing volumes is likely to come from the buy-side, who they predicted will take greater control of their order execution rather than relying on their brokers. As much as 10% of trading in the US utilises dark pools; the question is when that level of activity will be replicated in Europe.

According to Smith at NYFIX, it seems that the dark pools are suffering from relatively modest hit rates, of only 5% when applied with dark order types. Dark order type hit rates rise somewhat to 30% when interacting with the visible order book.

"I think that cuts right to the heart of it – the challenge in a dark crossing system is to get the cross rates up," said Lederman. With appropriate engineering to create a network of users, there is the potential to save as much as 100 to 200 basis points, which is why end investors are excited by the opportunity. The prospects are especially great in the small - to mid - cap sector where liquidity is harder to source," he added.

Myers asked Crosswell, whose company enjoys an exchange's backing, a pertinent question. "Are you cannibalising your own business, or are you getting subsidised? How does this model work, because I can't see the maths stacking up that everybody is going to be a winner in this?"

But Croswell stated she felt there was a big enough pie for everyone to get a decent meal. "If you believe the incumbents, and I heard enough of them say this, there is a big enough pool out there and all the MTFs do is bring more liquidity," she replied. It remains to be seen if the same can happen. Some will feel that choice has resulted in liquidity fragmenting, and while other markets have coped with that by pooling it virtually, only time will tell if the same can happen in the European equity landscape.