Dark Pools: Volume, Volatility and Disclosure

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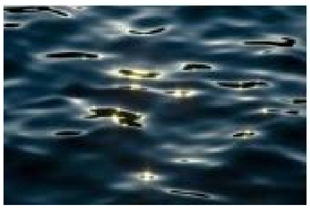


The new Celent report on dark pools cites data that trading off the exchanges (a wider category than "dark pool trading" specifically) has corresponded, at least in the U.S., with periods of low volatility in the lit markets.

Correlation does not imply causation, but often raises intriguing questions. Does off-exchange trading lower volatility on the lit markets? Or do periods of low volatility there help steer business into the 'pools.' Or is the foundation for this correlation something else?

Celent's hypothesis is that periods of high volatility are also periods of higher execution risk, and traders are wariest of dark pools at those times. In other words, the hypothesis is that the low volatility causes (or more strictly enables) the higher dark volume. But the authors of the report don't know what to make of the fact that there is no analogous correlation in Europe.

That piques my curiosity too. If the causative hypothesis is grounded in presumptions about trader psychology, then either those presumptions are quite general, applying to traders around the globe, or there should be some explanation why their working is nationally specific.

For now, I submit, the hypothesis should be considered a weak one, a just-better-than-nothing guess.

Technology and the Cascade

Another key (and less speculative) point in the report: average trade sizes are on their way down, and have been for five years. The average execution size in the U.S. was 430 shares in 2009 and is now just 200 shares. Why do the participants in dark pools trade in such small increments? The short answer, "Because they can."

Markets have evolved in a "cascade" since the implementation of Reg NMS in the U.S. and MiFid in Europe. Technological innovation has led to an increase in algorithmic trading and that has led to more high frequency trading and the whole combination has led to an increase of concern among retail investors and regulators.

Celent does not believe that the current levels of dark pool trading in either the U.S. or Europe are high enough to warrant regulatory intervention, although it does contend that a mandatory reporting requirement on trading volume is appropriate. "Getting a clearer understanding of trading behavior in dark pools, improved transparency and information sharing with clients … should be the focus areas at this stage."

The Financial Industry Regulatory Authority recently proposed a system for greater disclosure of trading activity on Alternative Trading Systems that would involve a unique identifier code for each ATS for reporting trades. SEC approval of the proposal is pending.

The Pool Has Its Good Points

Dark pools are, after all, not without their benefits, and a more heavy-handed approach (such as a requirement that orders **must** be routed to exchanges unless dark pools are able to offer price improvement) might have a chilling impact on these.

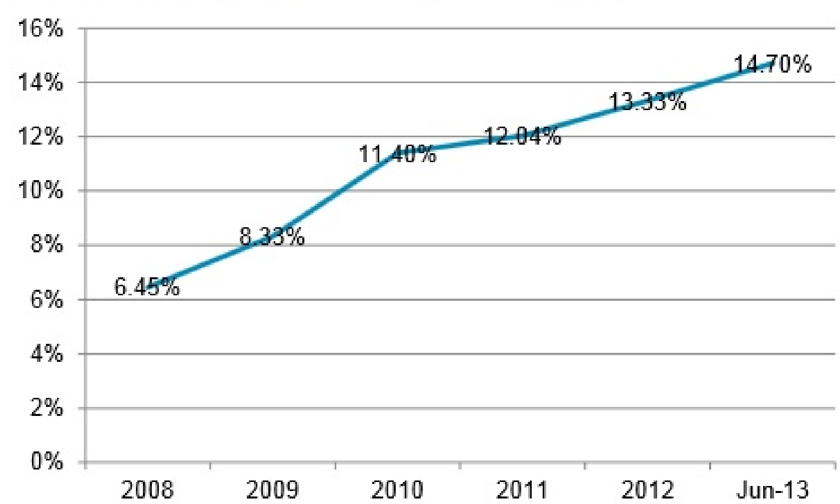
What are the benefits? Such trading minimizes market-impact costs, in the process helping limit leakage, and these are important points especially to pension funds and asset managers who worry about allowing other participants to front run their moves.

Separately, dark pools can enable price improvement "by usually trading at the mid-point within the spread offered by lit exchanges." One institutional block trading venue, Liquidnet, in March 2013 accounted for average net price improvement of 106 basis points. This is a significant improvement given the average execution size on Liquidnet of circa €900,000.

Finally, dark pools can minimize transaction costs.

As a consequence of these benefits, the share of equity trading volume accounted for by dark pools has risen steadily in the U.S. in recent years, as the graph below indicates.

Figure 3: Share of Equity Dark Pools' Trading Volumes in the US



Source: Rosenblatt Securities

As you see there: dark pools accounted for 14.7% of the total volume of equity trading in the U.S. in June 201s. This is more than twice the corresponding figure in Europe.

None of that implies that it will continue moving in the same direction. To the contrary, Celent expects some flattening out. Data suggest that "dark trading in the [U.S.] has entered a mature phase in the last two years and market activity appears to be stabilizing in terms of trading volumes." Further, in two to three years Celent expects to see an analogous plateauing in Europe as well.

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Author Bio:
Christopher Faille is a **Jamesian pragmatist**. William James has taught him, for example, that "you can say of a line that it runs east, or you can say that it runs west, and the line per se accepts both descriptions without rebelling at the inconsistency."

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