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Non-displayed Pools of Liquidity: Shining a Light into the Darkness

Myth 1: Dark pools live up to their negative connotations.

To some, the term “dark pools” sounds ominous, conjuring up images of great swathes of institutional liquidity moving around the market more or less out of regulators’ sight (if not out of mind). That such pools are not open to all market participants only reinforces this stereotype. And regardless of efforts to address dark pools’

image problem (one equities crossing network has instructed all employees to avoid using the term dark liquidity altogether, preferring instead the more banal “non-displayed liquidity”), some continue to question their value and implicit fairness.

This is, of course, ridiculous. Regardless of what they are called, dark pools address key

inefficiencies in certain markets, notably equities. The problems associated with trading size in the global equities markets have been well-documented. Market fragmentation, miniscule average trade sizes, slippage and information leakage – all of these factors, some of which are intertwined and mutually reinforcing, combine to decrease firms’ execution quality and increase the risk of market impact.

Difficulties with trading size are not limited to structural issues alone. In the US, Reg NMS was introduced to bring the equities markets into the modern age and protect investors’ interests via a number of key regulations, notably the trade through rule, which prohibits the practice of trading through better prices at other market centres. Yet this regulation takes a narrow view of best execution, focusing on retail investors’ interests by protecting limit orders. This can actually make it harder for institutions to trade size at or near the national best bid/offer (NBBO), not easier.

Crossing networks address these challenges by employing a variety of business models, yet all of them resemble each other in a few key respects: they are electronic systems that seek to bring together buyers and sellers anonymously for the purpose of trading block orders at or within the NBBO, either on a negotiated or auto-execution basis.

Equity crossing networks’ success to date clearly speaks to their value in today’s complex market environment. And the explosion of new offerings, from brokers, ECNs

and exchanges, means that everyone wants a piece of the pie. The key question, however, is whether the success of crossing networks in the equities market can be replicated in the FX market. That is, given the fundamental differences between the FX and equity markets, do firms – buy-side and sell-side alike – need or want access to a block FX trading system?

Myth 2: Given the enormous growth in dark liquidity in equities, the FX markets can’t be far behind.

When algorithmic trading became the equity markets’ newest buzzword several years ago, commentators soon began speculating about its emergence in other markets. FX, it seemed, was the consensus number one choice (despite already gaining a strong foothold in FX; the hedge fund community had been trading FX algorithmically for years). As algorithmic trading in FX became the next hot topic, FX, fairly or unfairly, was viewed as having fallen in lockstep with the equities market regarding advanced trading technology.

Similarly, when equity crossing networks caught people’s attention and the market began embracing this model in earnest, speculation ensued as to which market would follow. After all, if the crossing network model was adopted in equities, why wouldn’t it work in other markets? And if FX was the first market to follow the equity markets’ algorithmic drumbeat, why wouldn’t FX embrace dark pools as well?

The answer lies in the fundamental structural and regulatory differences underpinning the global FX and equity markets. The FX markets are extremely deep and liquid. Spreads are razor thin, especially in the major currency pairs. Even the secondary pairs are characterised by relatively tight spreads. In short, firms today have little difficulty moving blocks. Slippage and market impact are much less of a problem in FX than they are in the global equity markets. As such, the long-term success of FX crossing networks is in no way assured.

Myth 3: The buy-side would be the biggest beneficiaries of dark pool trading.

In the equity markets, it is commonly believed that the major beneficiaries of block trading are buy-side institutions. After all, crossing networks address the problem of information leakage, one of the buy-sides’ biggest fears, and significantly reduce execution costs. Yet the benefits of quickly executing size at or within the NBBO are not limited to buy-side firms. While the success of Liquidnet’s buy-side only model reinforces this stereotype, the success of other crossing networks like Pipeline, who opened their doors to the sell-side, tells another story (as does the creation of BIDS Trading, the newest equity crossing network to enter the fray, which is owned and operated by a consortium of leading brokers).

In FX, sell-side firms need to execute size on their own behalf. A few firms, including Lava, think the need is great enough to warrant the development of sell-side only



electronic crossing systems. Yet as noted earlier, there are structural differences between the FX and equity markets that raise the question as to whether block FX trading is a viable business model for any market segment, be it buy-side or sell-side. As such, whether the sell-side could benefit from block FX trading to same extent that the buy-side could is an interesting, if highly theoretical question. Of greater concern to those supplying block trading systems to the market is whether they will achieve any real traction from brokers or clients.

Myth 4: Dark pools are not new to FX.

The concept of bringing buyers and sellers together anonymously for the expressed purpose of executing block FX orders is new – so new, in

fact, that there is only one platform in the market today offering a block trading solution (MilanFX), and it is still in beta. Attempts to link block trading to any previous initiatives focused on only one component of these firms' business model: anonymity. Yet none of these platforms were dark in any real sense of the word. Take, for example, Hotspot FXi. The firm pioneered the CLOB model in spot FX; buy-side firms could participate on a non-disclosed basis and trade directly with other buy-side firms and dealers. In essence, Hotspot represented the market's first true ECN, based on the concept of centralised, anonymous trading. Lava followed with its own anonymous buy-side trading system, Lava FX, supported by dealer liquidity.

The fact that buy-side firms could now trade anonymously through such systems did not qualify them as dark pools, however. First and foremost, these systems emulate the traditional ECN model. With full depth of book and streaming executable prices, none of these platforms are particularly dark. Furthermore, average execution size on these and other platforms falls far below what one would consider a block order. A key component of the crossing network model is the focus on trading size. In contrast, average execution sizes on most buy-side e-trading platforms today hover around US\$ 5 million. Clearly, dark pools in FX is a new concept altogether.

Myth 5: Dark pools would face the same kind of toxic order flow that banks face in today's market.

A major problem facing banks today centres around the ability of

market participants to "game the system." Many dealers' quotes are automatically generated based on prices in the inter-dealer markets. Knowing this, some hedge funds have been known to place large orders significantly off the prevailing bid/offer spread in EBS, move the market, and then take out dealers' quotes when they move accordingly. Given how easy it is for firms to do this, there is concern about the possibility of firms using crossing platforms in an inappropriate manner (i.e. using high-frequency cancel replace strategies, stepping away from orders after eliciting market information).

However, FX block trading firms will certainly take a cue from their equity counterparts and closely monitor their platforms for such behaviour. Indeed, Liquidnet, the industry leading buy-side only equity crossing platform, routinely kicks users off its system for such abuses. BIDS, the new consortium owned crossing network, has scoring functionality in place that monitors users' performance and allows other firms to execute trades accordingly. Any FX block trading network that hopes to keep clients from fleeing its system will have to assure them that similar controls are in place.

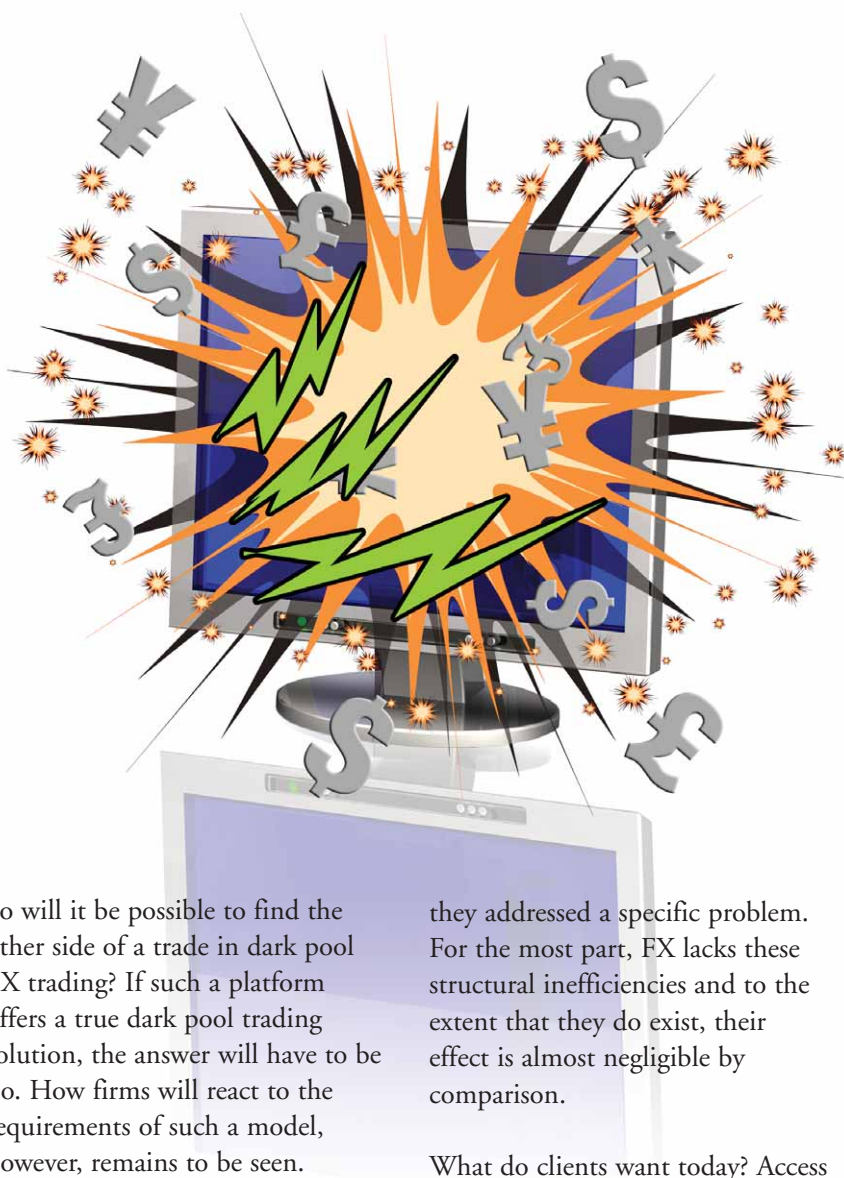
Myth 6: Dark pools would threaten existing ECNs and multi-dealer systems.

Crossing networks that move into the FX space would not pose a threat to existing ECN or multi-dealer platform order flow. As noted earlier, the ECN model as adopted by firms such as Hotspot and Lava FX is fundamentally

different from that of traditional crossing networks. The kinds of orders that are appropriate for the typical FX ECN are not appropriate for a crossing network, and vice versa. As for other multi-dealer platforms in the market such as FXAll and Currenex, trade sizes on these platforms are also relatively small compared to what one might find on a crossing network. Regardless, neither platform is currently set up to support such trading. As such, whatever liquidity these platforms currently enjoy will not migrate to a block trading system.

Myth 7: It's possible to find the other side of a trade in dark pool trading.

There are several structural differences between the equities and FX markets, discussed earlier, that come into play when analysing the potential use of dark pools. The most fundamental difference of all, however, is that FX operates as an OTC market, while the equity markets do not. This means that firms trading through FX block trading systems must grapple with the issue of credit lines. Trading itself may be anonymous, but at the end of the day there will have to be some sort of name give-up for settlement. For buy-side firms trading through a prime broker, this is not a concern. For sell-side firms who wish to remain completely anonymous, this presents something of a challenge. Providing full front to back anonymity will require the introduction of some sort of central counterparty to manage risk. That is, firms will have to open accounts with a neutral intermediary who would essentially clear the trade on their behalf.



So will it be possible to find the other side of a trade in dark pool FX trading? If such a platform offers a true dark pool trading solution, the answer will have to be no. How firms will react to the requirements of such a model, however, remains to be seen.

Myth 8: The landscape of dark pool trading in FX will look dramatically different in two years time.

Just a few years ago, the opportunities for non-displayed liquidity in the global equities market were modest by any measure. Today, the market supports over 35 different solutions, reflecting the enormous growth of dark pool trading in equities. However, it would be a huge mistake to look at the equities market and use it as a proxy for FX with respect to non-displayed liquidity. In the equity markets, dark pools were developed – and clients used them – because

they addressed a specific problem. For the most part, FX lacks these structural inefficiencies and to the extent that they do exist, their effect is almost negligible by comparison.

What do clients want today? Access to multiple liquidity points from a single trading management framework; the flexibility to incorporate FX into their overall trade workflow; the ability to pursue more advanced auto-hedging strategies and develop their own proprietary algorithmic solutions; low latency; reliability – all of these are of primary concern to firms engaging in electronic FX trading today.

So will the landscape of dark pool trading in FX look dramatically different in two years time? The answer, it appears, is no. FX block trading is an interesting concept in theory. In fact, it is simply a solution looking for a problem.