



Insider

How do you access sufficient liquidity without giving the game away? Frédéric Ponzo explores the concept of 'dark pools'

With the growth of alternative trading venues and MiFID on the horizon, the nature of liquidity in Europe is changing significantly. And as the buy side increasingly turns to the 'dark side', how will the banks and brokers stay in the liquidity game?

Take a walk on the 'dark side'

Liquidity is one of the most talked about concepts in today's capital markets. If there is too much of it, financial commentators issue dire warnings of another market bubble bursting. However, if there is not enough, investors become concerned that widening spreads will make it impossible to enter or exit existing investments and will increase the difficulty of raising future capital. To complicate things further, 'dark' pools of liquidity are emerging, which prevent accurate measurements and makes tapping into them a new and arcane art.

With the growth of alternative trading venues and MiFID on the horizon, the nature of liquidity in Europe is changing significantly. And as the buy side increasingly turns to the 'dark side', how will the banks and brokers stay in the liquidity game? Liquidity is the most important and most talked about aspect of the financial markets. But if liquidity is so important, why is it so elusive? Because, in short, if displayed fully, it contains a great deal of information. How can you bluff in a game of poker if you show your hand prematurely to your opponents?

The issue of liquidity provides investors with an interesting conundrum. On the one hand, they want to aggregate as much liquidity as possible to benefit from critical mass, while on the other, they want to keep their cards close to their chest and avoid being picked off. For example, if a fund wants to buy USD 100 million BT shares, it will only order USD 20 million from its brokers (20% of the total order), who in turn will only take 5% of the total order to the exchange at any given time (keeping the remaining 15% close to their chest). The majority of the volume, as much as 80%, is stuck 'upstairs' until it filters down the whole chain. It is a slow and inefficient process, hence the powerful attraction of the so-called 'dark pools'.

'Dark liquidity' is often defined as the act of trading equities away from an exchange, but in essence it is the process of bypassing the funnel. There are three distinct ways to achieve this: through alternative trading networks, systematic internalisers or directly via buy-side to buy-side deals. With the impending implementation of MiFID and the inevitable fragmentation of liquidity, the industry has begun to build an arsenal of technologies to try and solve the liquidity conundrum:

WEAPON #1: ALGORITHMS

It is widely assumed that trading with algorithms brings a certain degree of stealth to exchanges. However, by breaking down orders into tiny chunks, they also help to minimise market impact and help to capture even small pieces of liquidity.

WEAPON #2: INTERNALISATION

For institutions managing enough volume and a steady order flow, MiFID allows them to bypass exchanges and match client orders internally.

WEAPON #3: ALTERNATIVE TRADING FACILITIES

Whether it's Project Turquoise or Equiduct, the point here is to offer liquidity on a select number of assets to an exclusive club of members.

WEAPON #4: BUY-SIDE TO BUY-SIDE CROSSING NETWORKS

By allowing buy-side counterparts with mutual interests to interact directly, MiFID poses a serious threat to the sell-side's role in the financial markets.

As alternative trading venues continue to fragment liquidity under MiFID's guidance, we will see the continuing disintermediation of the sell-side in Europe. If the banks and brokers don't react to this change, we will increasingly see, or more accurately, not see, trades move to the 'dark pools'.

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