TRADING

# Dark pools offer benefits as long as lights are turned on

**Electronic trading has presented challenges to regulators with its lack of price transparency**

Richard Harris

The first stock exchange was started in Jonathan's Coffee-House in London 350 years ago and it was soon found that trading shares could be a fantastic way to make money. Despite the mantra of *Dictum Meum Pactum* (my word is my bond), such profits could be made unfairly.

A level playing field was therefore developed to give all investors an equal chance, consisting of a proper matching exchange with rules and eventually a regulator.

For those doing their CFA exams, a stock exchange also ensures that trades are cleared successfully and that the matched prices are fairly and consistently reported.

A stock exchange should be run as a utility, not unlike the Cross Harbour Tunnel.

The SFC recently closed its period of consultation on the regulation of Alternative Liquidity Pools (ALPs). It seems like the independent stock exchange business is very popular – there are 16 in Hong Kong – or that it makes a lot of money. One might hope that investors will benefit more than the exchange owners.

ALPs, or "dark pools", are stock exchanges where trades are matched electronically, without investors having pre-trade transparency, or first knowing the current price in the pool.

The price of the trade is reported to Hong Kong Exchanges and Clearing (HKEx) within a minute of the trade execution. "Lit pools" are exchanges like the HKEx, which publish prices as soon as the trade is executed.

Electronic trading has become a major challenge for regulators, because the proliferation of exchanges, especially in the US, combined with an ability to trade in nanoseconds, has led to trading irregularities and an erosion in price transparency.

Investors must know if they have traded at a fair price, and regulators need to know to prevent markets being manipulated. Traders, however, like "dark places" to prevent other traders second-guessing them.

Throughout financial history, dark places have encouraged conflict of interest. Say two matching orders occur within a fund manager, or a broker, or anyone with a pool of stock market orders; what commission do you take to simply cross the stock? If a client has to pay, say, 0.25 per cent to go through the market, you can charge 0.05 per cent, and no one loses out. Or you could charge 0.22 per cent each side; no one can tell.

This is very good business, and gets even better if no one is looking to see if you inflate crossing volumes, or the commission rates, or the price traded.

All of this might come as a surprise to today's teenage programmers, but none of this is new. It happened when high speed trading meant a two hour lunch and it happens now, just in nanoseconds. The principles are the same and are covered by existing regulations.

The banks and the trading houses are keen on dark pools because by taking business off the existing exchanges, they can re-intermediate stock trading at a time when technology has removed the banks from much of the trading process. Re-intermediation adds little value, except to the banks themselves.

**The one good argument for dark pools [is] that existing stock exchanges are outmoded**

Dark pools offer a competitive advantage in technology.

The arguments for dark pools providing more liquidity, reducing prices and reducing spreads do not hold up when markets go through crises, which is the only time when these things matter.

The only positive is that very large investors can trade in size. But in the old days, we would "work" a large trade through the market by being greedy when others were fearful and careful when others were greedy. This is the art of professional investment and large investors should be big enough to manage the risk without needing a privileged position.

It is extraordinary that the banks are not making the one good argument for dark pools – that existing stock exchanges are outmoded and inefficient. Technology should have revolutionalised the world of stock exchanges, creating just a few "super exchanges" around the world. After a flurry of merger activity by the major exchanges in the 2000s, things have slowed to a halt. It seems anachronistic for global titans like BMW, or Royal Dutch Shell, or GE to trade for just a few hours per day.

Dark pools could provide continuous weekday trading for global securities. This would give them a real competitive advantage against the existing exchanges, truly providing better liquidity, pricing, spreads and hedging opportunities than is currently available.

Dark pools have the technology, skills and resources to meet this unmet need and the benefits would be enormous. There is just one small change and that is they would have to turn the lights on! No regulator will allow a functioning global stock market without proper transparency.

This is an immutable principle – that all trading must be visible and recordable because this is the only way to run a fair market for all players. Dark actions can grow in dark pools, which is why the exchange first moved from Jonathan's Coffee-House.

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