Why dark is brighter than grey

For some time now a variety of liquidity pools have been widely referred to as "dark" – from "dark pools" operated as regulated MTFs to some of the more questionable forms of broker crossing networks. This has been a recipe for confusion and misunderstanding. Jan Jonsson, VP Product Management at Neonet, shines a light on some of the different definitions and explains why "dark" is actually brighter than "grey".

As much as we like to divide our reality into clear definitions, we are sometimes faced with mixed and overlapping terms. In the financial world, we refer to pools of liquidity as lit and dark, with the inference that they are two opposite extremes, but is it really that simple? As markets get more complex and new forms of trading arises, the term "dark pool" needs to be split and redefined, as there is great difference in transparency between dark pools and, what many now refer to as, "grey pools".

Lit, dark, grey – how transparent are they?

A lit market is, as the name implies, illuminated – it is possible to see and understand what is going on. You can make an informed decision pre trade, and then verify what happened post trade. This means that any problem that arises can be assessed, discussed and solved.

Whereas we define dark pools as "matching engines" that don't display any pre-trade information about resting orders to anyone. They are regulated under MiFID, with equal access and rules applicable to everyone. To obtain fair price discovery, they match on the primary exchanges' mid-bid or offer price. Execution is transparent and easy to benchmark as dark pools have a well-functioning price discovery mechanism.

Other pools match on order price and volume limits and not on a reference price such as primary mid-bid/ask. This enables execution of a block on a price that is negotiated and not pegged to a lit reference price – a hidden price mechanism. While the customer might want to pay a premium for executing the whole block without market impact, they are at the same time exposed to the risk of someone seeing that order and using the information, or that the price mechanism is tilted in one direction or other. These pools are often referred to as grey pools, and are not transparent and therefore harder to benchmark. Basically you need to trust the provider not to make money on both commission and spread. The networks don't add to transparency and this erodes trust in the market. Not everyone is allowed to trade in these pools and unless you are an owner, the fees to trade will be high. For the client, an alternative would be to allow for execution over time in a lit market.

As seen in the US, retail flow is often bought by brokers and traded off-exchange in a combination of prop trading market making, crossing and other techniques. Only a fraction of the flow slips through to a regulated dark or lit market, and when it does – having been sold two or three times – no one wants to meet the remaining flow. This is a sort of "super grey" handling of orders. In the US there is an obligation to give NBBO (National Best Bid and Offer) or better. In EU this is not the case; all you need to do is to follow your own best execution policy. As for the client, it is very unclear what service you are getting and how to benchmark it.

How price discovery differs

Price discovery is all about knowing what price you will get in the micro structure of the market, i.e. before you trade (at market price). For a dark pool it is easy; look at the best bid and offer of the primary exchange. The price is totally transparent, and easy to discover. The only dark aspect is that you don't know whether anyone will trade with you, and at what volume (the same as for passive orders in a lit book). However, after a trade is done the price can be verified by looking into historical bid/ask values. Pre and post trade transparency is therefore available for this kind of dark pool.

For grey pools, price discovery is left to the operator. You send an order to the pool – with limits in price and volume – and if you're lucky you get a hit. The best case scenario is that you get a better price than your limit.

So, how was the price set? Pre trade you have no idea. Post trade the operator has to report the trade within a reasonable time. You may see that the trade was done at your price and volume, but you don't know whether you traded with another actual investor, or if the operator took the position, with the purpose of trading it off a premium. The uncertainty in who you meet is the same in grey as in lit and dark, but in grey pools there is neither pre- nor post- trade transparency in the price discovery mechanism.

Price discovery is not possible without market data. You need the consolidated view to make an informed decision. However, each market has a monopoly on its own data. There are no alternatives to choose from, and where there is no competition inefficiency is strong. As already mentioned, in the US you are protected by the obligation to get executed at NBBO or better, whereas in EU you are not. In Europe the situation is further exacerbated by the lack of a consolidated tape to use as a reference to validate your execution quality.

Grey is dark, dark is lit

Adding transparency to execution might not be in everyone's interest, but as an investor it should be a top priority to know how your trades were made in terms of quality. It ranges all the way from pools to algorithms, and technology to brokers.

To trade in the dark adds liquidity, improves the price, and offers protection against small unwanted fills and pings. Dark is as bright as lit venues, and adds value for everyone, from a small retail customer to a big institution.

Blanket criticism of "dark pools" is misplaced and instead concern should be directed towards the fact that there are liquidity pools – incorrectly referred to as "dark pools" – without transparency that add to the confusion of the investor and their mistrust in the market; the so-called "grey pools". Concern should also be raised about the fact that there is a lack of access to consolidated tapes in the EU that would help customers get a complete view of what is happening in the market. The lack of a consolidated tape, and no obligation to offer good execution at EBBO (European best bid and offer) or better is a bad combination.

At Neonet we only trade in regulated lit and dark pools, never in grey pools. We use third party benchmarking to verify each and every trade in order to deliver a truly transparent and independent execution service with an optimised balance of quality and cost. Consolidated tapes have been part of our offering for many years. ■