Ask the experts: Dark pools

Barclays and Goldman Sachs were sued recently over their use of 'dark pools', but what are dark pools and why are regulators targeting them? Siobhain Egan, Director at Lewis Nedas Law, explains all

What are dark pools?

Dark pools are electronic Alternative Trading Systems that are very similar to stock exchanges where trades can be matched. The main difference is that in dark pools, the price at which shares are offered for sale cannot be seen by anyone – even those participating in the exchange. The price at which shares change hands is only disclosed after the trade is completed. This limits the amount of interaction between participants as they do not know when to move their price up or down in answer to the trade.

Although the term 'dark pools' is relatively new, the pools have been around since trading began and were previously called 'upstairs trading'. They are not a 'black market' trading platform. The prices and size of trades just are not displayed. A dark pool allows traders to buy or sell large amounts or 'blocks' without other traders knowing that the sale is being made. This prevents other traders from putting the price up or down and minimises the block trade's effect on the market.

Dark pools are not damaging to the stock market. The Securities and Exchange Commission (SEC) has recognised the importance for institutions to be able to work orders without displaying the whole order "to maintain long-term confidence" in the markets. Dark pools are highly regulated. All dark pools are broker-dealers registered with the SEC and the Financial Industry Regulatory Authority (FINRA) and subject to regular audits and examinations.

They are not environments where the participants 'go in blind'. Participants choose to place their orders in a dark pool. The users are sophisticated traders who understand the advantages of not displaying their orders at an exchange. Dark pool prices are not just made up, either. Trades are bound by the National Best Bid and Offer (NBBO), and prices cannot be chosen arbitrarily.

Why have dark pools become increasingly popular with traders?

Dark pools have become more widely used due to technological advancements that have lowered costs, allowing brokers and dealers to route more of the order flow they handle to their own private pools first, before sending unwanted orders to the public markets.

The volume of trade in dark pools is increasing because the system really works for institutions. The percentage of non-exchange trades has grown to roughly 33% of all trades, up from no more than 10% a decade ago. The likely reason for this growth is that users have had a better experience and more success using dark pools than they have had using regular exchanges.

Dark pools are not all the same. They have varying features to appeal to different segments of the market. Some only allow certain types of traders while others allow participants to rank trading partners and opt out of those they do not want to trade with. The main purpose of dark pools is to minimise market impact. By restricting access to undesirable market participants – for example, high-frequency trading firms – and by not revealing prices, dark pools enable institutional investors to minimise their information disclosure and realise more efficient executions.

More precisely, dark pools create the possibility of price improvement and lesser transaction costs by crossing orders at the midpoint of the quoted NBBO prices, which saves on both the bid-offer spread and on exchange fees.

Why are governments worldwide considering tighter regulation of dark pools?

Dark pools have been criticised for their lack of transparency, along with their potential to cause fragmentation, which can lead to less efficient pricing. This has led to growing calls for greater transparency of trading venues. It has also potentially opened up dark pool operators to wider legal action from government agencies.

Last year, in the US, the Chief Executives of NYSE Euronext, Nasdaq OMX and BATS Global Markets urged regulators to introduce rules permitting trades to only take place away from a public exchange if a customer is getting an improved price. These exchanges referred to steps taken by Canadian and Australian regulators to fight the rise of dark pools.

There may now be greater incentive to increase regulation of dark pools in the UK following legal action taken against Goldman Sachs and Barclays in the US. Goldman Sachs was fined $800,000 by FINRA for failing to ensure that trades executed in their dark pool were being made at the best price, while New York State filed a lawsuit against Barclays relating to high-frequency trading in its dark pool.

The fine and lawsuit follows the SEC’s announcement that it would review the transparency rules regarding dark pools in a bid to make them more open. Due to increased criticism and legal activity, some dark pools have in recent months voluntarily published information on how they operate. We can expect further light to be shed on dark pools in the months and years ahead.

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