

(Not) Trading in the Dark II

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Introduction

On March 31, 2010 we published the original Trading in the Dark paper, following a joint CSA/IIROC roundtable discussion on Dark Pools and Dark Order types. Last Friday, November 19th, the CSA and IIROC released a position paper (23-405) resulting from the roundtable – giving us an ideal opportunity to revisit our original Trading in the Dark paper and comment on this new position paper.

In our original Trading in the Dark paper we proposed five high level goals that any marketplace must meet in order to be deemed fair and orderly. They were:

- 1) **Efficiency** – Economical and efficient execution of securities transactions
- 2) **Fairness** – Fair competition among brokers and also among trading venues
- 3) **Transparency** – Fully transparent quote and transaction data being readily available to brokers, dealers and investors
- 4) **Practicality** – The practicality of brokers executing investors' orders in the best market
- 5) **Intermediation** – The ability for investors' orders to execute in the marketplace without undue intermediation

We referred to these goals as our ‘Golden Rules’ and used them to benchmark any suggested rule changes. The response to this approach was very positive, so we will once again use these rules to gauge the four clearly stated views in the CSA/IIROC paper.

That said we do feel the need to clarify one of our Five Golden Rules. It has become clear to us since the publication of our original Trading in the Dark paper, that the notion of transparency is both important and confusing. In arguing for transparency we are arguing for equal access by all dealers and investors to all trading data that is intended to be made public. This would include all trades and public quotes, but would stop far short of transparency around trader or investor intent. We further believe that all marketplaces should make their rules, procedures and matching logic transparent but should take all steps possible to ensure they are not, intentionally or inadvertently, making non-public client intentions transparent.

The CSA/IROC staff's views:

“The only exemption to pre-trade transparency should be for orders that meet a minimum size threshold”

In October of this year, the International Organization of Securities Commissions (IOSCO) published their own consultation report entitled, “Issues Raised by Dark Liquidity”. In that paper, they stated “all regulators consider transparency, both of current trading interest and recently completed trades, to be a core element in ensuring that markets operate in a fair, orderly and efficient manner.” The CSA/IROC paper borrows heavily from this when they state, “The posting of limit orders in a visible book is important to maintain the quality of price discovery. To achieve this, **limit orders should ideally be directed to, and displayed in visible marketplaces in order to facilitate the price discovery process**” (emphasis ours). They go on to suggest that only orders meeting a certain minimum size will be allowed to be placed in either a dark pool or as a fully hidden order on a lit market. (The CSA/IROC paper suggests the minimum size might be 50 board lots, but leaves this open for change. We assume they would see fit to make an exemption for the MOC facility, even though the paper explicitly stated that all dark pools including call markets would be included).

This leaves us to consider the notion of a minimum order size for fully dark orders. We would suggest that the proposed rule violates two of our five Golden Rules.

Firstly, forcing smaller orders to trade only on visible marketplaces threatens our suggested goal of fair competition amongst trading venues. Limiting dark pools to passive orders of a minimum size reduces the flow that they can compete for, granting an advantage to visible marketplaces.

Secondly, forcing smaller orders to have some visibility threatens the ability of investors to execute in marketplaces without undue intermediation. Anyone that has actively traded equities in Canada over the past 24 months is undoubtedly familiar with the impact even a small visible order can have on the quote book. As visible markets, both domestically and abroad, have created order types, data feeds and infrastructure that cater to the predatory end of the High Frequency Trading spectrum we have seen continued growth in the size and impact of order anticipation arbitrage in our marketplace. Forcing smaller orders to post visibly will limit the choices such orders have to avoid detection and gaming. Furthermore by limiting fully hidden passive orders to a minimum size, the regulators effectively limit interaction against dark orders to minimum size as well. If my order must be at least 5,000 shares to post passively in the dark, then I would be foolish to allow smaller active orders to trade against my dark order as such trades would clearly indicate the existence of my dark order to the market, and given my minimum size constraint the arbitrageurs would instantly gain some knowledge of my order's characteristics that could be used to trade against me.

While we agree that dark pools were originally intended to facilitate the matching of large orders with minimum informational leakage, not the continuous crossing of smaller orders away from the visible market, we are more inclined to address the issues that are incenting small orders away from the visible book rather than banning such order placement. We believe that in a well-functioning market, smaller orders will naturally desire to be posted visibly. We suggest the regulators take time to understand why investors and dealers are placing such orders in a fully hidden manner – both in Canada and elsewhere. We would suggest that as long as marketplaces are creating data feeds that functionally ensure arbitrageurs can trade ahead of natural market participants we will have a need for facilities that

allow such participants refuge. The notion of restricting dark to larger orders appears to be addressing a symptom rather than the illness.

Finally we note that should the regulators decide to move forward with this proposal, they may be surprised to discover that many of the smaller orders they believe will be posted in a visible market will not be posted at all. Many of the smaller orders in question are children of a larger order that is posted in the dark to avoid informational leakage. If these orders are banned from fully hidden order placement then broker built tools may be used to simulate such order placement. The marketplace has seen a very significant uptick in the usage of “pounce” style algorithms of the past two years, and we believe that many of the smaller child orders will use these strategies rather than posting visibly and extending undervalued optionality to the marketplace. If we are correct, the net impact of this change would be less instantly achievable liquidity resting passively within the marketplace, not more. This hollowing out of the books is one of the primary causes of the May 6th Flash Crash. We cannot state often, or strongly enough, the regulators need to address the issues that disincent the placement of more, and larger, orders on visible venues rather than trying to regulate such order placement.

“Two Dark Orders meeting the minimum size exemption should be able to execute at the NBBO. Meaningful price improvement should be required in all other circumstances, including all executions with orders not specifically marked in a manner indicating they are utilizing the minimum size exemption”

The debate around the need for price improvement has been well argued. We went to great lengths in our original Trading in the Dark paper to suggest sub-penny price improvement was problematic. We agree that two dark orders should be able to trade at the NBBO. Currently, with our multiple marketplace framework, the notion of priority is lost. A visible order placed on Alpha at 9:00 am may go unfilled all day while similar orders placed hours later on Chi-X get filled. As such, we don’t see any reason to prevent fully dark orders from trading ahead of fully or partially visible orders at the same price. While some may argue the need for a single consolidated book that returns time priority to the market, we don’t believe this will happen anytime soon. In the meantime our stated objective of fair competition between all trading venues suggests that if a Chi-X bid can “jump” the time priority queue then a MatchNow bid should be able to do likewise.

“Visible orders on a marketplace should execute before Dark Orders at the same price on the same marketplace. However, an exception could be made where two Dark Orders meeting the minimum size threshold can be executed at that price”

This proposal could actually have been written as two separate proposals. 1) Visible orders on a marketplace should execute before Dark Orders at the same price on the same marketplace. 2) Contra Dark Orders greater than the minimum size threshold can execute at the NBBO without ceding stock to the visible book. We will discuss the two parts separately.

Firstly, we agree that visible orders should execute on a visible book before dark orders on the same market. We have seen significant erosion in the value of visible order placement in the last 24 months and allowing dark orders to execute ahead of visible orders on the same book would only amplify this erosion. With that in mind, we note that regulators will have to consider the definition of “same marketplace”. Two of the visible Canadian markets currently have filed to create a second order book that is, at least from a regulatory sense, separate from their existing order book. This is consistent with the U.S. system where all of the large visible markets have two or more order books. If a trading venue is allowed to create a second (or third or fourth) unique order book that contains purely dark orders such that it circumvents this rule then we will have achieved nothing. At the same time we are concerned that related books interplay with each other in a way that is inconsistent with how they interplay with non-related book (e.g. we would not want a market venue SOR to be aware of hidden orders on two related but unique order books, as this creates unfair competition between markets – which is contra to our original stated objectives). In order to clearly determine the value of this rule we will need some clarification from the regulators on how they plan to address marketplace operators with two or more order books.

Having stated that we believe that visible should trade ahead of dark on the same venue, we would note one significant exception. We believe that allowing marketplaces to create dealer internalization systems that allow same dealer dark orders to trade ahead of other visible orders will disincent larger dealers from creating their own internalization systems that will be less transparent and will likely reduce the portion of desk orders that are exposed in an instantly transactable manner. (The regulators clearly state at the start of their paper that they will be dealing with the issue of “broker preferencing” at a later date. We find it difficult to conceive of dark pool and dark order regulations that do not address broker internalization systems). We strongly suggest that broker internalization is a natural defence mechanism used by brokers to limit order gaming. As a dealer we are only able to control the order flow of one market participant, and as such we are positively disposed to trading with our own clients first as we have vetted them and deemed them to be upstanding citizens. While others may choose to rent out their trading number to the predatory tail end of the high frequency spectrum, we may choose to turn away such flow and should then be able to enjoy the benefits of more natural trading partners. The critics have argued that such systems will be used by bank dealers to the benefit of their proprietary trading systems. This concern could easily be addressed by allowing such internalization to occur only when the passive side is an agency order. We are of the belief that the benefit of allowing a dealer with a large order on a relatively illiquid stock to post a passive dark order and capture internal retail, DMA and algo flow without the constant need to visibly peg to the bid (offer) and expose the order to unwanted gaming will allow for reduced market impact of larger orders. This is consistent with our goal of efficient and economical trade execution.

Secondly we look at the notion of allowing two larger orders to trade at the NBBO without interacting with visible posted orders. We are positively disposed to any regulation that incents, but does not force, greater placement of instantly transactable orders. By allowing large contra dark orders to match without interference the marketplace rewards the placement of larger orders into the system. This should create greater achievable liquidity within the system at any given time, resulting in reduced market impact for larger orders – which is completely consistent with our objective of economical and efficient execution of trade. We would suggest that the inferred minimum threshold of 5,000 shares may be far too low on highly liquid names (e.g. BBD.B), but otherwise are in agreement with this proposal.

“Meaningful price improvement means that the price is improved over the NBBO by a minimum of one trading increment as defined in UMIR, except where the NBBO spread is already at the minimum tick. In this case, meaningful price improvement would be at the mid-point of the spread”

In our original Trading in the Dark paper we wrote at length on the issue of sub-Penny Price Improvement. At the time we wrote that “we would be more favourably disposed to sub-penny improvement if the resulting trades were large suggesting both participants had achieved some level of size discovery”. We still believe this to be true. We are pleased that the regulators are moving away from sub-penny price improvement and support this proposal fully.

Conclusion

The almost complete upheaval of Canadian equity market structure over the past few years has resulted in the arrival of new trading systems, policies and participants whose value is unclear. We believe that investors and their appointed dealers need to be given a wide berth in choosing the manner in which they fulfill their best execution obligations. Removing strategic tools from the traders’ toolbox, and forcing more visible and transparent order placement may well be contrary to the goals of the end client. The global porting of smaller orders to dark venues has been a natural evolutionary tactic to avoid the parasitic gaming that currently occurs in visible market venues. Disallowing such tactics in Canada, without first addressing the asymmetrical treatment of differing client sets by visible marketplaces would appear to be dangerous and arbitrary. The CSA/IRROC statement that “orders entered on a marketplace should generally be transparent to the public” alongside the IOSCO comment that “(a)ll regulators consider transparency, both of current trading interest and recently completed trades, to be a core element in ensuring that markets operate in a fair, orderly and efficient manner” ignore the cost of such visible order placement. You would be hard pressed to find many long term participants in the Canadian market who deem the current dark Market on Close facility to be anything but superior to the old fully transparent last tick rules system. Visible quotes are undoubtedly important, but we believe that regulator should aim to incent orders towards visible placement by ensuring the cost of such order placement are not overly onerous rather than by banning dark order placement for some or all orders.

We would recommend that regulators consider the architecture, data feeds and pricing of the various lit markets – and the impact these may have of order gaming before adopting regulation that limits investor and dealer options to avoid such gaming.

We understand that these issues are complex, and often times there is not one right answer. We congratulate the regulators on having published this important position paper and urge all of our readers to read, consider and comment on it. (Those wishing to comment publically have until Jan 10th, 2011 to do so).

We would be thrilled to receive feedback from our readers – even those of you not on our original distribution list – on any of the issues addressed. As always, we look forward to many lively discussions on this paper.

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