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WEEKEND EDITION

## The secret stock market

### 'Dark pools' and other new-age exchanges rewrite the rules, under the radar

By [David Weidner](#), MarketWatch  
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**NEW YORK (MarketWatch) --** Fourteen floors above Seventh Avenue, in an office more than a mile from the trading floor of the New York Stock Exchange, a trumpet sounds reveille over a loudspeaker.

Liquidnet Holdings Inc., an alternative trading system used by institutions, has just executed a block trade of a million shares or more.

#### Shades of murkiness Players in alternative exchanges

##### DARK POOLS

Liquidity Ping, VortEx, PositNow, Continuous Cross Buyers and sellers are matched anonymously

##### CALL MARKETS

Opening Cross, Posit Match Trades executed at market prices but done anonymously

##### NEGOTIATION POOLS

Liquidnet, BIDS Buyer contacts and bargains with seller

Unlike the bulk of trading in stocks, this trade was made anonymously and was executed outside of the market where retail investors and institutions meet. And unlike a trade on the floor of the New York Stock Exchange, no one will ever know who put a million shares up for sale and who just bought them.

Liquidnet is one of dozens of new private trading networks that -- in just two years' time -- have ushered in a sea change that challenges Wall Street's top institutions while posing vexing questions for regulators and investors alike.

Driven by the boom in electronic trading and other technological advances, a range of upstart entrepreneurs now are doing the kind of bulk trading that up until a few years ago was practiced exclusively in upstairs trading rooms at big brokerages like Morgan Stanley and Lehman Brothers.

"We're in the middle of a revolution," said Tim Mahoney, chief executive of BIDS, a trading system launched by a consortium of top-tier Wall Street firms.

These so-called alternative trading systems are propagating rapidly, are often labeled "dark pools" because of their nebulous and murky nature. Estimated to handle about 1 out of 10 shares traded each day in the U.S., dark pools are meeting a need by institutions to grab or dump stocks quietly -- and anonymously. Like Liquidnet, many of them sport imaginative brand names in a nod to science fiction, such as Sigma X, VortEx and Block Alert.

In the harsh light of a public marketplace like the floor of the NYSE, an institution trying to pull off a massive trade runs the risk of making a big splash that will move the market. But in a dark pool, a big fish can jump in without so much as a ripple.

### 'Both the innovators and exchanges are profoundly affected and, depending on their actions, will reap the benefits or squander the opportunities of dark pools.'

— *Jim Ross, NYSE*

In a matter of months more than three dozen dark pools have taken shape, creating a new and wild frontier that is largely unregulated. And the industry is growing so fast regulators can't keep up. Moreover, some observers fear these private marketplaces could take too much trading volume from the public markets -- putting retail investors at a disadvantage.

What's certain is dark pools have radically altered the way big institutions trade. And because private trading networks are extremely profitable, an array of old-line Wall Street firms is following in the footsteps of independent startups that have carved out the industry's hottest new niche.

"Execution-only technology has become a big business," said Jim Ross, vice president of MatchPoint, the dark pool that the NYSE is poised to launch next month

Purveyors of dark pools, also known as alternative trading systems, have taken a small investment in technology, as little as \$20 million, and produced a business, that in the case of that Liquidnet trade, will produce \$20,000 in fees, or 2 cents a share.

In return, investors who are looking to shed or buy huge blocks of stocks obtain anonymity and avoid moving the price of the stock by showing their hand.

As Dan Shaffer, owner of Shaffer Asset Management, put it at a dark pools conference recently, "Anytime you put an order in the system, the smart people know about it and talk about it."

Without the easy access granted by dark pools, big institutions would have to move big orders through the market by calling a broker who would, in turn, send that market to the floor. As the information leaked -- first to the broker, then to the floor -- an investor's intentions were exposed.

But in a dark pool, a big institutional investor like Fidelity Investments or New York Life can shop or put a buy order out for stock without alerting a regular broker. Though alternative trading systems aren't water-tight, they do minimize

information leakage, traders say.

"There's leakage everywhere," said Robert Gauvin, director of equity trading at Pioneer Investments. "It's just a matter of how much."

But with every revolution comes struggles. These markets are largely unregulated and because of the anonymity are open to abuse. They are, at times, inefficient. Critics say they run counter to the spirit of new market regulations by the Securities and Exchange Commission that require that investors get the best price available for their order.

### Who's in?

Such concerns have failed to hamper the growth of dark pools. A decade ago there were no platforms outside of traditional broker-dealers where trades could be executed. Now, there are 500 million shares a day trading in dark pools and that number is expected to swell to 1.35 billion by 2010, according to the Tabb Group, a market-research firm based in Westborough, Mass.

A combination of technology and profit potential are driving a boom of startups. The Tabb Group estimated there were 38 dark pools up and running as of May 1. Among them are three major categories of services that represent varying shades of anonymity.

- Some are true dark pools, where buyers and sellers are matched anonymously. Players in this segment include Liquidity Ping, VortEx, PositNow, Continuous Cross and Pin.
- Call markets such as Opening Cross and Posit Match execute trades at a price -- usually set by the public market -- anonymously.
- Negotiation-based pools, run by the likes of BIDS and Liquidnet, which match up buyers and sellers who then bargain on a deal price.

As for the owners, the most common are actually the old-line brokerages. Goldman Sachs Group Inc. ([GS](#)) has Sigma X. Merrill Lynch & Co. ([MER](#)) runs Block Alert with a company called ITG and Citigroup Inc. ([C](#)) runs the ACE platform.

BIDS, launched earlier this year, is owned by consortium of brokers and banks including Bank of America Corp. ([BAC](#)), Bear Stearns Cos. ([BSC](#)), Credit Suisse ([CS](#)), Deutsche Bank AG ([DB](#)), J.P. Morgan Chase & Co. ([JPM](#)) and Knight Capital Group Inc. ([NITE](#)).

Exchanges such as the International Securities Exchange ([ISE](#)) Nasdaq Stock Market Inc. ([NDAQ](#)), NYSE Euronext ([NYX](#)) and Instinet run 10 of the platforms, and a few, such as Liquidnet, Pipeline Trading and NYFIX are independent.

### Retail investors

As dark pools take a larger share of the market, individual investors may be losing out, critics say. For instance, a big sell order of 1 million shares might, to the chagrin of the seller, drive down the price of stock XYZ if it hits the floor of the NYSE or the order book at the Nasdaq. Defenders of the system say that's how the market should work.

In an automatic dark pool, that order might get filled without affecting the price in the public markets.

But Seth Merrin, who runs the Liquidnet system, argues that even as dark pools expand -- Merrin prefers the term "wholesale market" -- most retail investors will continue to get small orders matched in the public market. To his mind, most so-called individual investors are actually savvy day traders.

Still, to level the playing field, Liquidnet has developed a platform called H2O where individuals can place orders. "There's going to be better prices for everybody," Merrin said.

And, dark pool advocates point out, big institutions actually are running funds -- through retirement and pension accounts -- that often make trades on behalf of ordinary people.

"Small investors are benefiting from these pools of liquidity," said Harvey Pitt, a former chairman of the SEC who now runs a Washington-based consulting firm. "The institution reflects the individual."

To many of those behind the dark pools -- entrepreneurs and tech heads who cut their teeth in jobs at electronic exchanges -- the nascent industry's rapid growth came out of necessity. The volatility of prices and whimsy of retail investors trading on the exchanges after the tech bubble burst left behind a changed landscape. Cutthroat competition from new, low-cost electronic markets erased already thin profit margins.

"It got to be a lot harder to make money in these markets," said Kevin Callahan, head of sales and strategy at JonesTrading Institutional Services LLC, a third-party trading platform.

Dark pools also took advantage of a slew of regulatory reforms -- new rules governing stock trading, the move from fractions to decimals in the marketplace -- at a time when established exchanges such as the NYSE were caught playing catch-up.

"Exchanges have been complacent, and people thought of new and innovative ways of doing things," said James Leman, who helped build trading platform and networks at Citigroup Inc. and HSBC Holdings. "So we're seeing a lot of experimentation."

The result is a mishmash of platforms with different flavors. Some, such as Liquidnet's are aimed at institutions. Some, such as Fidelity's CrossStream, are owned by institutions. Thirty-three of the 38 major dark pools split about 208 million shares a day in volume, or an average of nearly 7 million shares a day.

Even at that small amount, it's possible for an alternative trading system to make good money -- revenue of \$138,000 with the 2 cents-a-share standard.

Meanwhile, new dark pools are coming. In June, the NYSE's MatchPoint after-hours crossing system will use an algorithm to slice and dice orders and baskets of orders. It is a hybrid of many features already in the market. The NYSE already has four crossing products but they only trade NYSE-listed stocks, are linked to the exchange's public order-routing system, and have no capability to trade portfolios or baskets

Jim Ross of the NYSE acknowledges the Big Board is late to the dark-pool game. But, he said, a new dark pool can be successful if it's innovative enough to bring trading volume to it. The NYSE is banking on its new technology and the power of its brand name, but it also hopes that the legitimacy of its regulatory arm will help drive trading to MatchPoint.

"Barriers to entry have been lowered significantly," Ross said. "Both the innovators and the exchanges are being profoundly affected and, depending on their actions, will reap the benefits or squander the opportunities of dark pools."

Some long-time traders aren't so sure that the industry hasn't passed the exchanges by.

If the growth seems unsustainable, that's probably because it is. Many of the systems have low rates of filling orders. Simply put, orders presented there often go unfilled and that's why most agree that the number of dark pools is likely to shrink during the next five years.

"Market forces are self correcting," BIDS' Tim Mahoney said.

## New traders

For those who use the systems, the more liquidity that the dark pool offers, the bigger the commitment from the trader.

"We're getting more done on Pipeline than we are on the floor," said Joseph Gawronski, president of Rosenblatt Securities Inc. which handles trades for large institutional clients. "At the end of the day if we're doing 500 shares on Pipeline, we're doing 400 on the floor (of the exchange)."

But the use of technology and the greater dependence on it has fueled a rapid change in the traders' world. Just a few years ago handheld paper tickets were strewn on the floor of the NYSE. Now, complicated algorithms move millions of shares to different markets -- public and private - with the push of a button.

"The lines continue to be blurred between the tools and the venues," said Robert McCooey, former NYSE floor broker, now in charge of private equity customers at the Nasdaq Stock Market Inc. "It's science and no longer art. The art has been driven out of the process."

But not everyone sees the nuances of trading disappearing. Some market professionals say there are still too many variables for computer formulas to handle.

And the number and offerings of dark pools have made maneuvering a trade through the markets a confusing process. There are negotiated markets for those seeking a better price, there are crossing markets for those looking to buy or sell big blocks at the market price. There are dark pools that discriminate against hedge funds. Some will take all-comers.

Leslie Boni, managing director at UNX Inc., which provides trading tools, networks and platforms for institutions, said at a conference recently that there's tremendous demand for new trading technology in the market. Hedge funds are constantly demanding the latest tools, furthering the suspicions among some other traders.

"The hedge funds think of themselves as traders first and managers second," JonesTrading's Callahan said at the same conference. "They want nothing more than for traders at big institutional funds to punch that information into an algorithm, so the (hedge fund trader) can exploit that information."

## Regulation

Mistrust of hedge funds is also the product of a landscape that is relatively lawless. SEC rules governing dark pools went into effect in 1998. Most agree that those measures, which allowed dark pools to become exchanges or broker-dealers, or neither by keeping their volumes low, is already outdated.

"Regulators have enormous problems," said Pitt, the former SEC chief. By the time regulators enact new rules, "the world has passed the statute by."

Pitt maintains that the dark pool name has hurt what is essentially a wholesale stock-trading industry.

"When I think of dark pools I think of the dark side and Darth Vader," Pitt said, adding that their lack of transparency does run counter to the regulatory emphasis on disclosure.

New rules for public exchange trading emphasize that customers should get the best price available, regardless of whether they're posted at the NYSE, Instinet or any other public market,

Unlike other markets, in dark pools "a level of transparency can lead to manipulation," Pitt said. On the contrary, the proliferation of dark pools also presents a problem: too many anonymous players and that "can produce disproportionately bad pricing."

Historically, the SEC didn't know how to regulate a market that looked like an exchange but wasn't an exchange.

For instance, brokers trade on their networks but also act as police, creating a conflict. Hedge funds are controversial players. Some systems exclude them and when Liquidnet offered to include them to boost its market share in a competitive market, some existing customers threatened to pull out.

Different venues have different rules. Pipeline doesn't force clients out of the system altogether, according to founder Fred Federspiel. When a violation is found, Pipeline rebuilds the platform to prevent abuse. "We have had to kick a few people out until we got a fix deployed," he said.

The discord over rules may change with the SEC's appointment of Erik R. Sirri, a Babson College economist, as the agency's chief market regulator in 2006. Sirri has said the commission is reviewing, not acting, on the issues presented by dark pools.

## Competition

So, of these more than three dozen players how many will survive? That's the question on the minds of everyone who's in the market. Though there's uncertainty on which platform will be standing in three years, there is agreement about what will decide it: liquidity.

If you keep placing orders in a market that go unfulfilled -- as many are today -- it's unlikely that venue will keep getting your order, according to Mahoney.

"How much liquidity is really out there for dark pools?" said Edgetrade's Wald. "I think it's underestimated. The actionable liquidity has grown drastically."

Traders are finding that they can deal in bulk orders that never existed in the past -- hundreds of thousands, even millions, of shares.

Some dark pools may actually seem unsuccessful, but because they've captured a small part of the market that was not being served, they can survive.

Ultimately, most market participants agree that dark pools will expand, but never become a substitute for the public exchanges.

Many industry participants say alternative trading system landscape is much like that of the electronic stock markets in the late 1980s.

"There was consolidation," Mahoney said. "It came down to who had the better tools, the best functionality, pricing and fill rates. It's the same everywhere. Mass chaos literally transformed the way the markets were run and now they're infinitely more efficient." ■

*David Weidner covers Wall Street for MarketWatch.*

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