ADVANCED TRADING

Optimizing dark pool liquidity

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Over the last six years, liquidity has been an increasingly difficult commodity to detect and access in an electronic trading landscape that has become more and more fragmented. The growth in direct market access, program and algorithmic trading solutions has diffused the opportunity to detect liquidity--whether block level or sub-1000 shares.

And as if multiple exchanges and ECNs weren't enough, internalization options provided by brokers have mushroomed. Many of these systems have evolved into alternative trading systems (ATS), where liquidity is reported to reside but cannot be seen with the naked eye. A diverse group of more than 30 of these new liquidity points has further complicated the electronic trading playing field for both buy- and sell-side firms.

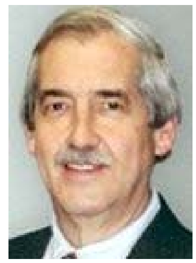
Faced with this level of complexity, the stage is set for a new discipline, "liquidity guidance or consulting" to emerge to address traders' needs in this new era of Regulation NMS and its associated market structure realities.

The Buy Side's Challenge

To contend with this more complex and abstract world, buy-side firms must, as always, know the construction of their portfolios, the names they hold, the size of their usual trading activity, and the expectations of portfolio managers and trading management. In addition, firms now need to understand the nature and idiosyncrasies of the different pools of liquidity, so they can formulate strategies that match their appetite for stealth and their willingness to be patient, and take advantage of the optimal mix of these liquidity points.

Clearly, not all ATS' are created equal. Some, like Pipeline, are specifically designed to detect block liquidity with no visible market exposure or information leakage. Others, like BIDS and Liquidnet, target the block trading space but provide different wrinkles in terms of trading, participant composition or information exchange. Others, like Instinet and Posit, offer periodic crosses with midpoint pricing (Posit also offers continuous crossing through Posit Now and Block Alert). Still others, like ISE, offer midpoint pricing but in a more continuous mechanism. lt is not possible to do justice here to the variety of features offered by these providers, especially as some will appeal to block players, others to algorithmic strategy users, and others to program traders or DMA users.

Given this new trading landscape, buy-side firms now need to determine how their brokers' tools to access liquidity compare with their own ideal solution. They will



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need to know if their broker internalizes flow, if their broker has an ATS, if the broker is part of a group of brokers investing in exchanges or ATS operators and if the broker has ruled out any liquidity points for competitive reasons. And they will need to develop "liquidity detection proficiency" or rely on their brokers or others to guide them on their liquidity options.

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To a certain extent, it's a forgone conclusion that the buy side will need to access exchanges and ECNs because those venues have published quotes. Firms may also choose to access dark pools to minimize market impact, maintain anonymity and manage execution costs. They need to weigh their appetite for using these liquidity pools against the trading time that may be lost while their order is going through these systems.

Not all orders are appropriate to negotiate via dark pools. In addition to trading blocks of stock via screen-to-screen negotiation, orders can be given to an algorithm tuned to go to the right liquidity point with the optimal potential for a match. Or the dark pools can be bypassed altogether.

Small trades can be sent directly to the exchange or through an ATS on their way to the exchange, or they can be sent to a broker. Algorithms, like implementation shortfall strategies, make sense for mid-sized trades that need to be worked efficiently. Algos like these will look for flow in dark pools using automated pinging techniques or will access midpoint match options. When costs incurred are a key issue for users, destination selection for mid point matching could be affected.

The jumbo, hard-to-do trades require more active human intervention. Traders with these types of trades would probably favor ATS designed for block-type interaction.

Buy-side firms need to assess which orders they will manage directly and which are best placed with brokers, and make this decision based on tools available and results expected. Some firms may decide to let the broker take complete control, and judge performance based on the final execution results.

With the implementation of Reg NMS still ahead, changes in buy side strategies are at a very early stage. Trial and error may well mark the initial efforts to take advantage of these myriad liquidity opportunities. Complicating the matter of determining the best fit for your firm is the fact that these ATS are a moving target—some of them haven't even been brought to market yet.

Issues for Brokers

Broker-dealers also must make connectivity decisions, but they need to provide an array of options because their customers come in all shapes and sizes. They can either put in their own pipes to connect to various liquidity pools, or they can opt to use another broker's connectivity services. Using another broker's system can be a "starter kit solution" for brokerage firms still testing the waters of ATS connectivity.

If they are going to go the route of using a broker for dark pool connectivity, both buy- and sell-side firms have to determine which broker to use, based on how the range of services being offered best matches with their particular trading needs and objectives.

Brokers that decide to develop their own solutions will be faced with a variety of questions: Build or rent algorithms? Develop tick databases or use a vendor provided solution? Develop strategy servers to cover the full range of strategies clients are looking for? Create an internalization solution or participate on an existing platform?

Brokers also must evolve their menu of offerings to provide a "liquidity consulting" service via either their own personnel or an outside consultant to help their clients—and the brokerage firms themselves--decide the who, what, when, where and how of ongoing liquidity detection.

And whether they build it themselves or use another broker's connectivity solution, brokers, like buy-side firms, will need to have an ongoing process to evaluate the effectiveness of their strategy. They need empirical evidence such as average order size, etc., to ensure that ATS they're using are the ones that best suit their specific goals. They also must design compliance, regulatory and management reporting tools.

Firms also must determine whether they have the staff to support the challenges that a significant matter like this requires especially since the focused thinking and decision-making required may not be a one-time event, but rather an ongoing commitment.

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