

## Dark pools

The scepticism around dark pools that was once prevalent is rapidly diminishing as the benefits of accessing their liquidity is acknowledged.

Nevertheless, the lack of transparency can make traders cautious about how and when to tap into hidden volume.

A fear of gaming is at the heart of this unease, yet interaction with dark pools requires similar techniques to those used in any efficient execution. Traders have always tried to buy a stock as cheaply as they can by understanding the market supply and demand, and these principals are at the heart of how we interact with any dark pool. In a 'lit' book a trader may try and take a small offer to see if more liquidity appears or the stock gaps up – equally trying to understand the dynamic of a dark pool supply of liquidity is central to any interaction.

At the heart of all interactions is the aim to disguise your intentions to others, by sending appropriately sized orders in a randomised manner for execution at fair prices. The two key risks are someone detecting that you have a large order or obtaining

# Dark pool interaction – managing the risk of gaming

The potential for gaming in dark pools can only be assessed by understanding the liquidity in each pool and an individual's investment objectives, says Phil Allison, head of client trading and execution, UBS.



Phil Allison

executions at a disadvantageous price.

Whilst similar techniques can be used to access various pools, two components are central to defining the optimal interaction. The first is the nature of the pool with which you are interacting, and secondly the investment objectives behind the order.

### Dark pool characteristics

Every pool is uniquely defined by the participants that access it and the rules and fee structure that govern that interaction.

For example, when developing our internal pool in Europe, we have always focused on ensuring the 'quality' of the liquidity. As such, the only access available to internal or external users is through our algorithms. Crosses only happen at the mid-point, and only when analysis of the recent movements

of the stock price suggests that this is a fair price.

If we allowed all DMA and prop trading into the pool, and crossing at price points other than the mid, we could clearly substantially increase the amount of client flow we cross from the current 15%. But doing so would change the nature of the existing pool.

There is nothing inherently wrong with other pools that attract a large amount of high frequency stat-arb participation. Exchanges, after all, allow all participants to trade on an equal basis. It is not a bad pool of liquidity; it is simply a different pool. Exposing a large block may well be foolish, but small, randomised orders may allow substantial amounts of liquidity to be sourced over time. Equally, a pool with a large minimum crossing size, high fee structure

and restricted participant access would require an entirely different order entry strategy in order to effectively access the potential volume.

Diversity of dark pools, and competition amongst them, is generally a positive for investors – creating greater price competition and introducing diverse liquidity to the market.

### Investment objectives

The second key part of working any order using dark pools is to understand the investment objective. Typically, clients are simultaneously aiming to find volume and minimise adverse price movement. The relative importance of these two criteria depends on a number of factors such as the size of the order and the short-term alpha of their investment process.

For example, a client with a large order may wait until good size natural liquidity can be found before starting to trade. Others may set a low participation rate and take dark liquidity opportunistically. Those who feel they have a lot of short-term alpha may be much more aggressive, seeking liquidity from all possible venues simultaneously.

As we understand the objective, we can advise on the best execution strategy and algorithmic options (including customisation) to enable effective access of all liquidity sources. In doing so, we are re-creating in electronic form the trading interactions that have always been core to the business – understanding at what price levels and at what points in time finding liquidity will improve the overall execution, and when holding off is the best solution.

In summary, dark pools are neither something to be feared, nor a venue in which to assume every fill will be desirable. Whenever an execution takes place some information is given to the market. As markets continue to fragment and new dark pools are created it is crucial to understand their nature and have clear strategies to find liquidity in the optimal manner. Accessing all viable liquidity pools in a manner appropriate to their characteristics and your investment objectives is the ultimate aim. ■

This information is communicated by UBS AG and/or its affiliates (“UBS”). In some countries, UBS AG is referred to as UBS S.A.

This material has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and is published solely for information purposes. No representation or warranty, either express or implied is provided in relation to the accuracy, completeness or reliability of the information contained herein, nor is it intended to be a complete statement or summary of the developments referred to in this material. This material does not constitute an offer to sell or a solicitation to offer to buy or sell any securities or investment instruments, to effect any transactions or to conclude any legal act of any kind whatsoever. Nothing herein shall limit or restrict the particular terms of any specific offering. No offer of any interest in any product will be made in any jurisdiction in which the offer, solicitation or sale is not permitted, or to any person to whom it is unlawful to make such offer, solicitation or sale. Not all products and services are available to citizens or residents of all countries. Any opinions expressed in this material are subject to change without notice and may differ or be contrary to opinions expressed by other business areas or groups of UBS as a result of using different assumptions and criteria. UBS is under no obligation to update or keep current the information contained herein. Neither UBS AG nor any of its affiliates, directors, employees or agents accepts any liability for any loss or damage arising out of the use of all or any part of this material. © UBS 2008. All rights reserved.

