



Keeping your orders  
top secret is our top priority.

## Are Exchanges Converging with Dark Pools?

By Ivy Schmerken

Mar 20, 2008 at 02:16 PM ET

The lines between exchanges and dark liquidity pools are blurring. Last week NYSE Euronext announced that clients of NYSE Arca's electronic trading system would have access to non-displayed liquidity pools through participating broker-dealers and alternative trading systems.

NYSE Arca will launch the routing and price improvement service with 29 participating-broker dealer participants and non-displayed liquidity sources. "Trading interest from these venues will be included in the NYSE Arca routing algorithm," according to the release, which claims NYSE Arca is the first exchange to offer its clients access to non-displayed liquidity.

I thought this was big news. After all the goal of most exchanges is to match orders internally within their own order books, but with the fragmentation of liquidity spread across 40-plus non-displayed liquidity pools (a.k.a. broker-operated dark pools and third-party crossing networks), buy-side customers want the exchanges to aggregate liquidity. And if there's a chance they can hide their intentions, avoid market impact and execute at better prices, then it's all for the good.

However, NYSE Arca is not the only exchange routing to dark liquidity pools. I spoke to a few industry sources and several immediately told me that this reminds them of Direct Edge, the ECN owned by Knight Capital Group, that recently took in outside investors (Goldman Sachs Group and Citadel Derivatives Group, LLC).

"Direct Edge deserves credit for being cutting edge in deciding to incorporate routing to non-displayed liquidity pools as part of its displayed market," said Joe Gawronski, president and COO of Rosenblatt Securities, an institutional agency broker. In fact, Rosenblatt predicted six months ago in its market-structure analysis newsletter (Trading

Talk, Oct. 11, 2007) that “displayed markets will continue to ... push out more non-displayed alternatives.”

Then I spoke to Direct Edge. In the last year or two, Direct Edge has offered high speed routing to a vast network of liquidity sources. “Today we did close to 40 million shares a day of routing to dark liquidity pools,” says Bryan Harkins, head of sales and strategy at Direct Edge, which is averaging 650-to-750 million shares a day.

“The New York just getting into this just gives us a tremendous amount of credibility and echoes what we’ve been saying all along — that it gives customers a tremendous amount of value,” says Harkins.

In fact, other exchanges have done this in various flavors over the years, notes Harkins. “The concept of non-displayed liquidity or IOIs (indications-of-interest) has been around for many years,” says Harkins. Direct Edge calls it the Enhanced Liquidity Provider Program or ELP. The ELPs are various dark pools with which Direct Edge has formed relationships. So far, Liquidnet H20’s, which lets broker liquidity stream into the Liquidnet buy-side pool, is the only dark pool relationship that Direct Edge has disclosed.

So, does this mean that NYSE Arca is emulating Direct Edge? Not exactly, say students of Arca’s history. Sang Lee, managing partner at the financial services research firm Aite Group remembers when Archipelago was an ECN, both Island and Instinet were matching 100 percent of their trades internally, whereas Archipelago and BRUT (then led by William O’Brien, who is now Direct Edge’s CEO), had a 20-to-40 percent internal match rate. The two ECNs figured out that to build liquidity they needed to build a smart order routing technology and connect to all of these other execution venues, says Lee. “For Arca it wasn’t about the fastest matching engine, but looking for the best price,” says Lee. Both Arca and Brut figured out how to make money out of order routing and increase their match rates, he adds.

And to be fair, Direct Edge is not necessarily the first ECN to incorporate routing out to non-displayed liquidity sources. “While Direct Edge was the innovator in routing out to dark pools, in this case and it deserves acknowledgement for that, routing out to other destinations is part of Arca’s DNA so I wouldn’t call it a copy-cat or say that this is a surprise,” says Gawronski.

Furthermore, the idea that NYSE needs to get dark to stem the loss of liquidity to ECNs like BATS and dark pools, has been floating around and NYSE Euronext has been taking steps in that direction with the launch of [NYSE MatchPoint](#) and the [BIDS Trading block-trading joint venture](#) as well as the [Project SmartPool joint venture](#) to form a Pan European block trading system. Gawronski notes that NYSE Arca’s sister company, NYSE, has a joint venture with BIDS, and central to that is plan is the integration of displayed and non-displayed markets.

Many of these dark pool-oriented ventures have materialized since electronic trading executive Larry Leibowitz joined NYSE Euronext last June as Group EVP, Head of U.S.

Markets and Global Technology from broker-dealer UBS, which had its own dark pool (UBS PIN). So perhaps, this is not about copying someone else's strategy, but more about NYSE Arca getting back to its roots in smart order routing technology. No doubt, we'll continue seeing new models emerge with public exchanges integrating both displayed and non-displayed order books.

For example, The ISE Stock exchange successfully operates both a displayed market and the ISE MidPoint Match, a non-displayed market. But the ISE is not routing out to external dark pools, so it's not the same as what NYSE Arca is doing. As the market structure evolves, don't be surprised if exchanges converge with dark pools. Why that's already happening — Direct Edge plans on filing to become an exchange.