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Trading in a Dark Pool? Watch for Sharks

Posted by MarketBeat Staff

Rob Curran reports:

The proliferation of alternative electronic stock exchanges known as dark pools puts institutional investors at higher risk of shark encounters.

Dark pools find matches for blocks of shares without publishing the orders or the identities of the institutions. But that anonymity can also give cover to sharp operators known as “gamers.” These traders sniff out large orders, and then try to use that knowledge to trade against the block at a profit.

“They look for big dumb elephants leaving big footprints,” said **Joe Saluzzi**, head of equity trading at **Themis Trading**.

Say, for example, a mutual fund wants to buy a big block of shares and places an order in a dark pool. Unlike on a traditional exchange, nobody can see that order until they match it – at least in theory.

In most pools, the order will be executed piecemeal, broken up into 100-share chunks until such time as a big block of shares goes up for sale. That’s why gamers often “ping” a pool, sending in a rapid succession of small-lot offers to see if there’s a buyer out there taking the bait.

In the same way a shark senses the presence of big prey from small blotches of blood, the pinging can tell a gamer that there’s a big buy order in the dark pool. By buying up stock in a series of small lots, the predatory trader will replicate the block in their own portfolio, driving the price up with each trade. Once the gamer has accumulated a block, they turn around and offer it for sale at the peak price, gouging a profit from the buyer.

Many of the roughly 40 dark pools have some kind of antigaming measures in place. Yet traders say they are surprised at how little institutions know about the nature of these defenses and the foes they are facing.

“I strongly encourage anybody that uses any pool to have a good understanding of how that pool operates, who’s in the pool and who’s monitoring the pool,” said Steve Greenblatt, head of sales and trading at Liquidnet, the largest dark pool not operated by a broker-dealer.

Standards vary from dark pool to dark pool, so traders must remain conscious of the rules of the pool they’re in and watch for dorsal fins breaking the surface. “If you’re getting tapped by odd lots, if it happens 40 times ... you’re being gamed,” **Mr. Saluzzi** said.