

Buy-Side Technology

Smart Order Routing: Dancing with the Devil

Author: Jake Thomases
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Sal Arnuik, co-founder, Themis Trading

Because brokers receive next to nothing in commissions, it is accepted that brokers program their SORs to visit their own dark pool first. That can easily be undone, but the only way to do it is by asking. By Jake Thomases

Buy-side firms need not wonder if their orders are being placed first in their broker's dark pool, says **Sal Arnuik**, the co-founder of **Themis Trading**. They need not wonder because it is certainly happening. It's a process he understands but accepts reluctantly, calling its origin "a dance with the devil."

"There's no such thing as a free lunch," he said at the Waters USA conference in New York. "Yes, you pay half a penny now for algorithms and you don't get six cents a share anymore but on the buy side for you to get those cheaper commissions, you've given something up. You've given up control of your orders. You've placed the economics of your routing decisions in the hands of your broker."

With brokers receiving next to nothing in commissions, they have to make their money elsewhere. They do it by programming their smart-order routers (SORs) to visit their own pool first, hoping to complete the trade internally. All brokers that own their own dark pools do it, he says, including that of the panelist to his left, Nomura's Val Shlivko.

"You can completely ignore everything he just said about our internal dark pool. We absolutely don't do any of that," Shlivko said to a round of laughter, suggesting that the industry is in on the joke at this point.

If it's true that all broker-supplied SORs start their journey in an affiliated dark pool, then it is also accepted that no pre-packaged smart-order router is as smart as it could be. Best execution doesn't begin in the same place every time. But Shlivko was quick to offer an antidote.

"The important thing is, most brokers will work with our buy-side and sell-side clients to make sure we tailor our smart-order router exactly to the requests that you have, and exactly to your specifications," he says. "We'll provide you transparency as to what venue is executed, cost, where we route it. It's all there available. The important thing is to ask."

The safe method for any investor, their conversation suggested, is to assume there is a conflict of interest. Check the routing strategy with your broker, and if you don't like it, they can change it for you.

Arnuk calls his algo providers regularly to tweak his SOR, altering the acceptable venue list and instituting minimum order sizes for others. A good SOR has its technology aligned with the needs of the buy side and the investors.

The panelists also debated the value of low latency in a smart-order router. While **Arnuk** pointed to a Wall Street Journal op-ed authored by TFS Capital's Richard Gates that warned of latency arbitrage in dark pools, suggesting that low latency is critical, the others downplayed its importance. Venue selection through proper data analysis is as significant, Shlivko says. Tabb's Miranda Mizen agreed: "Latency is always a concern. But with a smart-order router if you don't know what's on the other end then you might be quick to get somewhere you don't particularly want to be."

Shlivko also pointed to the act of getting the order into the SOR. If that takes 20 seconds, he says, it doesn't matter how fast the SOR is.

Mizen anticipates a huge leap forward in SOR technology. Not an incremental jump, but a big arms-flailing leap, precipitated by market conditions. "You're going to see a whole new generation coming along," she says. "Because I think there isn't a lot of appetite right now, in a hugely volatile trading environment, for a wrinkle or a bell. It's got to be a quantum leap. Otherwise there's a lot of people just trying to get through the day right now."

The Bottom Line

- Since brokers don't make much off commissions, they are programming their smart-order routers to visit their own dark pools first.
- While this goes against the idea of best execution, the industry has accepted this practice as being an inescapable fact.
- Buy-side firms should take it upon themselves to be in contact with their brokers to tweak their SOR strategies so as to be optimal for the firm.
- Even with how much SOR technology has already evolved, it is expected that there are still major gains to be made.