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DARK POOLS MAY OBSCURE MARKET PRICES

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(This is part of a series about dark pools of liquidity, increasingly popular anonymous trading venues that are changing the way stocks are bought and sold around the globe.)

A new obsession by big investors with veiling their stock trading patterns is rewriting the rules of the stock market, but some are questioning if the trend, for all its secrecy and sophistication, has created as many problems as it has solved.

The stealthy but rapid growth of off-exchange trading venues, known as dark pools of liquidity, may be playing a bigger role in the market than some expected.

Only a few years ago, investors could count on one hand the number of places to trade stocks in, for example, U.S. companies.

But today traders must navigate a virtual ocean of more than 40 venues to find the best prices -- a phenomenon that may be adding to overall volatility and possibly compromising the validity of all stock prices.

In dark pools, where buyers and sellers anonymously match large stock orders keeping details about price and volume concealed, there is no guarantee that even big investors are getting the prices they should.

"My biggest concern with dark pools is that before, when you were using the Big Board as somewhat of a standard, you were trading with some level of information, and now in dark pools you are trading without information," said Bob Koci, a trader with Principal Global Investors, based in Des Moines, Iowa.

Investors have become accustomed to knowing the quoted price on traditional stock exchanges like the New York Stock Exchange, or Big Board, and Nasdaq, is generally fair and the best available at any point in time. But as trades are increasingly fragmented across different venues, making such assumptions in the future could be dicey.

"On one hand, there are trades being executed right now that would not be executed without dark pools," said Robert Iati, a partner at market technology consulting firm The Tabb Group in New York.

"On the other hand, you can say, well it's not visible and that makes it more volatile."

GOING DARK

Some investors have always looked for ways to hide their cards, such as slicing a large block trade into smaller pieces, or placing a reserve order that displays a small amount of liquidity while keeping a larger amount hidden. However, recent advances in electronic trading and the 2001 switch to trading stocks in dollars and cents instead of fractions are credited with pushing traders into more secretive venues.

As investors found it increasingly difficult to trade discreetly on open markets, the average size of a stock trade on an exchange fell from close to 1,500 shares per trade a decade ago, to just 250 today, Tabb's Iati noted. That trend developed at the same time hedge funds and institutional investors found it profitable to make riskier, more leveraged bets at faster speeds, he said.

"Indirectly, you have the market structure changing," Iati said. "Now it is much more challenging overall for any investor to make money like they did 10 years ago in the plain-vanilla U.S. markets."

Alternative, off-exchange trading systems, ranging from dark pools to electronic networks were set up rapidly to address demand. Some pools are sponsored by brokers like Goldman Sachs Group Inc's Sigma X, while others such as Liquidnet and BATS Trading were created independently or as joint ventures. Now even the exchanges are setting up their own pools to remain competititive.

In dark pools, traders looking to buy or sell large blocks of stock get something akin to a wholesale discount.

When investors see a large buy order on a public exchange, they often jump in and bid up the price of the stock, assuming a big trader is making a strong bet about its direction. But if the trader who made the order is still trying to fill it, the price for the stock can move against him, adding to costs.

Hiding the bid from the public markets in a dark pool offers traders the ability to fill an order without suffering the impact of other traders changing the price.

"MIXED VERDICT"

Trades in dark pools are now estimated to account for some 10 to 12 percent of all stock trades, and consulting firm The Aite Group predicts that by 2011 dark pools will encompass more than 20 percent of market share in the United States.

But reaching such a critical volume of stock trades, could begin to affect the basic supply and demand equations used to price stocks, analysts say, as investors' true feelings about how a stock should be traded are hidden.

NYSE President Catherine Kinney summarized the problem at a 2006 conference, saying every share traded in dark pools was one that did not help the markets determine an accurate price for that stock.

And while analysts cautioned recent market volatility is mostly due to economic worries and the subprime mortgage crisis, many said it is possible that hidden trades in dark pools are contributing to the storm.

"Lack of a central marketplace can add to volatility," said Andrew Silverman, managing director of electronic trading at Morgan Stanley.

According to the Aite Group stock trading on the NYSE and Nasdaq represented just 75 percent of average daily trading volume in the third quarter of 2007, down 5 percent from the second quarter of 2006.

Investors can also react more quickly in dark pools because they don't have to splice and dice an order and trade it throughout the day.

But on the flip side, no study has been published on whether dark pools increase volatility, or decrease it by limiting the market impact of trades.

"There's kind of a mixed verdict on dark pools," said Craig Pirrong, a finance professor at the University of Houston's Bauer College of Business. "On one hand they provide competition (for exchanges), on the other they probably reduce the quality of price discovery marketplaces like the New York Stock Exchange."

When traders meet in a dark pool, they are not necessarily looking to get the best price on their stock trade, but rather, the most efficient execution so they can limit market impact.

However, the execution price for trades in dark pools is actually derived from public quotes on exchanges, so dark pool traders are essentially "free riding" on the way public market investors price their transaction.

"If a retail customer puts in an order that is very well priced, and it becomes the best price available, all of a sudden, all these investors in dark pools have to trade off of that price," said Bernard Donefer, Associate Director of the Subotnick Financial Services Center at Baruch College in New York. "The national best bid offer could be created by small retail investors. It used to be the opposite. It used to be that the institutional investors set the price and the retail investors got that price."

While some analysts say arbitrage traders would jump in and fix discrepancies between dark pool and exchange prices, it could become increasingly difficult for investors to assume the quoted exchange price takes into account all the trading information about the stock.

"The theory is if you keep it confidential you get the better price," said Frederick Lipman, a corporate and securities lawyer at Blank Rome in Philadelphia.

"Whether that's true or not remains to be seen."

(Reporting by Emily Chasan; Additional reporting by Phil Wahba and Kristina Cooke; Editing by Eddie Evans)