With dark trading escalating globally, investors and regulators alike are starting to become a little scared of the dark yet little is known about the market quality impacts of their introduction.

Dark pools are one of the hottest topics in finance today. Supporters argue that they allow large traders to execute orders without incurring significant price impact due to front-runners. Opponents point out that the lack of pre-trade transparency allows informed traders to ‘hide’ their trades and allows those with access to the dark to ‘jump the queue’. Unfortunately very little conclusive evidence exists... UN-TIL NOW.

A new study by Sean Foley and Dr Talis Putnins finds evidence that we should not be afraid of the dark, especially darkness in moderation.

On 15 October 2012 Canada became the first jurisdiction in the world to curb the conduct of so-called ‘dark pools’. The regulator mandated all orders without pre-trade transparency (dark orders) must provide one full tick of price improvement to the prevailing best bid and ask. The rationale for such a move was to prevent situations, such as in the US, where dark orders trade at the same price as the underlying market ahead of lit (transparent) orders. With more than 30% of US trades occurring in the dark, many claim dark trading is harming price discovery.

The introduction of the minimum price improvement regulation in Canada was a bold move by the regulator as there was little evidence as to the impact it might have on the market. Foley’s research utilised the immediate drop in dark trading caused by this event to assess the impact of dark pools on market quality.

Foley’s study finds that low levels of dark trading improve measures of market efficiency, by increasing liquidity, reducing transaction costs and increasing pricing efficiency in the lit markets. In a market that is heavily entwined with the US, opponents of the legislation claim that such regulation would lead dark trades to migrate to the USA. However, the research analyses a matched sample of stocks and finds no evidence of such a ‘regulatory flight’. The research also suggests the existence of a ‘tipping point’ beyond which dark trading is detrimental. The tipping point is likely to differ between markets.

Other recent research by the CMCRC on dark markets suggests that there are major problems with the way such markets are structured in the US. (see Segmentation Costing US Investors Billions).

The Capital Markets Cooperative Research Centre is a world-leading research organisation that provides thought leadership and break-through technology solutions for capital and insurance markets (www.cmcrc.com).