Analogies to movie titles are purely coincidental... The Markets in Financial Instruments Directive (MiFID II) was introduced in 2007 to harmonise financial markets, strengthen investor protection and increase competition throughout Europe.

One of the consequences of the implementation had been a grown demand for dark pools, trading venues which circumvent equity pre-trade transparency requirements. The pre-trade transparency regime, i.e. the obligation to make public current bid and offer prices and the trading venues which circumvent equity pre-trade transparency requirements. The pre-trade investor protection and increase competition throughout Europe.

In literature, liquidity is often referred to as being a multidimensional concept with the dimensions being tightness (transaction costs), immediacy (or likelihood) of execution, depth (number of orders above and below the current price formation from a market microstructural perspective. In theory, dark pools are associated with unreported orders, while in lit exchanges, informed traders are looking for fast, reliable execution. This notion assumes that trading without pre-trade transparency is of particular benefit for traders looking to benefit from price improvements. Following this model assumption, retail order flow is benefiting from dark pools once it avoids the risk of adverse selection and higher costs of trading on lit venues. This theory has demonstrably proved outdated in several respects. Technology, to name but the most significant factor, has led to an increased number of market participants that focus on gathering all available pre-trade information in the market and to front-run on it based on super-lux/latency.

In order to limit the amount of trading under certain waivers (the RPW and NTW3) and thereby to prevent harming the price formation process, MiFID II introduced the double volume cap (DVC) mechanism. This mechanism caps the transactions that are allowed to be executed under the RPW and NTW at 4% at a venue level and at 8% for all venues throughout the European Union. If these thresholds are reached, competent authorities must make sure that dark pools must suspend trading for a period of six months.

It will not surprise you that market participants are looking for ways to circumvent this rule. Too. As ESMA has noted in 2018 already.

"Trading flow previously executed under one of the two waivers covered by the double volume cap, is in particular flowing to systematic intermarketers and periodic auction trading systems."

ESMA added that, since the first suspension of dark trading in March 2018, trading volumes on periodic auction trading systems have tripled. It may be assumed, however, that ESMA, if deemed necessary, will adopt further measures to intervene.

As mentioned above, the regulatory framework has left enough space for large black blocks to trade exempt from pre-trade transparency. This is the case for dark pools. It is noteworthy because the majority of orders in dark pools do not qualify for the (C), in that they do not justify an exemption from pre-trade transparency. Moreover, prices in dark pools are not resulting from demand and supply within the dark pool, they are derived from lit market reference, i.e. orders in dark pools (without price formation) in the extent to which they would otherwise (when executed ex-ante) contribute to the lit market order book depths as they would represent a degree of information available before the price is being discovered.

Dark pool prices, conversely, are a sole function of the execution at a certain level - intrinsically increasing volatility and thus having an adverse effect on retail trading costs through spreads and liquidity. Another, recurring phenomenon that has beenmanifested again very recently should discourage retail investors from engaging in dark pools: if market volatility adds to the liquid execution infrastructure of dark pools and if the market is in selling mode, the order will not be executed - sometimes the platforms cannot be kept up at all.

To end on good news we can discharge the market of the misconception that the emergence of new lit markets, such as Spectrum, would have an adverse effect on liquidity. Fragmentation in visible order books - as a study of the Centre for Economic Policy Research [CERP] has found - improves global liquidity. Whereas dark trading has a detrimental effect. But this is a topic for our next issue...

To be continued.

More than a decade has passed since the implementation of MiFID I and its revision on 1 January 2018, MiFID II – and one of the most severe financial crises in capital market history. Including all delegated and other implementation acts, the revised regulatory framework fills roughly twenty thousand sheets of paper. Industry concern that a withdrawal of the two rules would be depopulated into MiFID II, did however prove unfounded.

In that context, it is worth looking into how dark pools have been influencing market structure and market functioning. Buy-side firms have been arguing, as it is the custom of high liquidity in that they bring participants to the market that would not have been there otherwise. Second, the maintenance of exchanges would mean lower costs, preventing the broker from incurring spread costs in association with accessing a lit order book that otherwise puts the buyer at a disadvantage. Third, the absence of exchanges would expose the investor to a higher risk of the market moving against his interest (due to the pre-trade information then being shared with the market).

The term, particularly in Europe, has made the dark trading venue an all-seeing eye over the aggregate market order book. This issue has been subject to much criticism and has led to intense regulatory scrutiny. The main two criticisms are that dark pools allow for fragmenting markets while MiFID II, substantiating this approach for non-equity instruments and, among other things, imposes a detrimental effect. But this is a topic for our next issue...