Philequity Corner (May 12, 2014)
By Valentino Sy

Fear of the Dark

Almost a month ago, we wrote an article on the issue of broker anonymity (*The Dark Side*, April 14, 2014). In that article, we explained the risks involved with adopting such a policy in light of the advent of high frequency trading (HFT) and private opaque exchanges called "dark pools." Our goal in writing that article was to bring the issue to light and encourage a healthy debate among market participants.

The PSE's management has since replied with a piece titled "Shedding Light on 'The Dark Side'" which was written by the PSE's COO, Mr. Roel Refran. The article, which was written on May 2, 2014 and is archived in *The Philippine Star's* website, explained the PSE management's take on the issue. Thereafter, we received a letter from Mr. Khoo Boo Boon, a veteran investor and one of Philequity Corner's more informed readers. Below is his email to us.

Khoo's Request

Dear Valentin Sy,

First, let me congratulate you for your article "The Dark Side" which appeared in The Philippine Star's Business Section on April 14, 2014. I take that article as your advocacy for a better-informed investing public on issues that might impact them. I have also read the response of the PSE's COO to your article. I find his response lacking in terms of objectivity in articulating the imperative for the proposed plan by the Exchange to dispense with the current broker identity rule. I am pleased to share with you my reaction to the said response and I hope that you can have this published in your column. It is my hope that this reaction will tease, "disturb the mind" and hopefully stimulate an active discussion among other market participants and the investing public on a proposed plan that is sure to have serious ramifications in the market, once implemented. Please find my reaction to the response of the PSE's COO to your article.

Yours truly,

Khoo Boo Boon

Khoo's Letter Reaction

"Light travels faster than sound. Isn't that why people appear bright before you hear them speak?"

- Steven Wright

I am using the quote above to illustrate this classic example of when regulators know not what they are doing. Instead of shedding light, they bring forth a worse kind of darkness. They try to defend something that they do not comprehend. They repeal rules without really understanding the circumstances that brought about these rules in the first place. While they claim to fight for transparency, market integrity and market quality, their actions do the reverse by restricting market surveillance to one entity or body. In defending their untenable position, they cite as reason something to this effect, to wit: "Studies have shown… blah blah…" to support their position without citing the specific studies. We know that whenever someone uses that kind argument, he or she is engaging in deception, pure and simple. If indeed there are studies which support their position, then why are they afraid to reveal these studies? A proper, objective and intelligent review of these studies must be made, as well as a thorough comparison with studies that yield contrary findings.

With regards to the issue at hand, I can cite specific studies to show that market quality metrics such as confidence, liquidity and efficiency improve in trading regimes where counterparty identities are known. One such study is that of the Korean Stock Exchange – a study titled "Shining a Spotlight on Counterparty Identity in the World's Best Lit Market" by Thu Phuong Pham, Peter L. Swan and P. Joakim Westerholm. Another earlier study done at the University of Sydney titled

"Effects on Fragmentation and Market Quality When ASX Moves Towards a More Anonymous Market" also shows that market quality suffers in an anonymous trading regime.

The truth and fact of the matter is that after the 2008/2009 US stock and financial crisis, there have been measures to move against anonymous trading in dark pools. Similarly, the EU is looking at measures to curb anonymous trading and by its nature the manipulation of markets. I am thus amused that while other countries or exchanges are closing in on dark pools, the PSE is opening the floodgates for them. It is interesting to note that the London Stock Exchange is looking at a measured step to limit transactions within dark pools (anonymous trading platforms) by capping these to a maximum of 10% of volume, with any excess to be executed via an auction system. It is an accepted fact that there is information asymmetry in the market and that informed traders benefit more from a broker anonymity regime as compared to non-informed traders. Moreover, in exchanges in the UK where there is a choice for traders to select between an anonymous market and a non-anonymous trading platform, informed traders tend to migrate to the earlier platform. This has created an aberration in the market and this 10% limit is now being considered as a measure that would address this challenge.

I am also taken aback by the abuse of the phrase "best practice" in describing broker anonymity in this article. If best practice is taken to mean a commercial practice that is prescribed and accepted as correct or effective, then certainly this 'broken' broker anonymity practice, which both the US and EU exchanges are working to fix, will not qualify. By the way, the reason why most of the exchanges in the US and the EU adopted broker anonymity is not because of the inherent goodness of the system. The adoption was basically driven by competition among themselves.

I am equally stunned by the over-emphasis of liquidity as a measure of market effectiveness in light of the claim that "ensuring the integrity of the market is at the core of the functions of the Exchange." Liquidity and transparency are not mutually inclusive as there is such a thing as "dark liquidity." This pertains to liquidity for the "big boys" (read the "more informed") at the expense of small investors (read the "less informed"). This also refers to liquidity that is available for those who can front-run or fix prices.

Let me just end this brief with an explanation regarding the logic of the current practice at the PSE and other similar exchanges, where pre-trade orders posted do not show broker identifiers while post-trade orders which have been matched show both the buyers and sellers. There are two primary reasons behind this arrangement. First, this practice is meant to be a check-and-balance against any collusion between the buyers and sellers. Second, since there is information asymmetry in the market, the identities of market participants that are shown post-trade compensate the less informed traders by giving them information on what is happening. These can then serve as guides in their trading decisions. Certainly, the intent was not to create a herding effect when this arrangement was first conceptualized.

Caveat: This comment reflects my personal view and does not reflect the stand of any of the organizations that I am affiliated with. The intent of this brief is to tease, "disturb the mind" and stimulate a healthy and intelligent discussion among market participants and the investing public.

Noble intentions of the PSE

We encourage our readers and investors to read the piece written by the PSE's management. The article, which is archived in *The Philippine Star's* website, contains the views of the PSE's management and their explanation of the rationale behind the proposed rule change.

We believe that the PSE has noble intentions in pushing for changes in trading rules such as broker anonymity. We are certain that they reviewed and studied the prevalent practices of various global exchanges, looking for possible policies that may be applied to our stock market. Moreover, we agree with the PSE's management that small investors should trade based on research and the latest company disclosures available in the PSE's website. However, as mentioned by Mr. Khoo, recent developments on the rising influence of HFT and dark pools are prompting even the biggest exchanges in the world to thoroughly review their trading rules. Hence, it may be wise for us and our regulators to do the same.

Favorable for Philequity

The proposed broker anonymity rule is indeed favorable for Philequity and other big institutional investors. As one of the bigger mutual funds in the country, our various brokers provide us with insightful research and various updates on what is happening in the market. Aside from this, Philequity has a big research team which makes detailed studies of listed companies and looks at the latest developments in the stock market. Therefore, broker anonymity is advantageous for big funds, as this would shield their moves from being telegraphed.

Left in the Dark

But the fear of Mr. Khoo is that once broker anonymity is implemented, small investors might be shut-out and be left in the dark. These small investors do not have the access and information that bigger foreign funds and institutions are provided by their many brokers. Broker anonymity may therefore highlight the information advantage that big hedge funds, foreign and local institutional investors already have against small retail investors. More importantly, big foreign funds with access to algorithmic trading platforms would be able use these technologies more freely in a broker anonymous trading environment.

A Call for Dialogue

Though broker anonymity is actually favorable for Philequity, recent developments regarding HFT and dark pools have made us rethink our initial positive response about the proposed rule change. Moreover, these developments have prompted us to adopt a more neutral stance about the issue. We understand the PSE management's views, but at the same, we share Mr. Khoo's legitimate concerns. Just like Mr. Khoo, we are wary that huge foreign funds may end up having an unfair advantage vs. everyone else, especially considering their access to high-tech algorithmic trading platforms and how these may be used in a broker anonymous environment.

Considering this, Mr. Khoo's call for a healthy and intelligent discussion on this topic among market participants and the investing public may be warranted. It would also be wise to consult experienced traders and investors who have been immersed in various global markets like Mr. Khoo. They see HFT in action and understand how dark pools work. Thus, they may be able contribute to a more enlightened understanding of these dark forces and how the proposed rule changes might affect our stock market.

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