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1 trading terms

Dark Pools

What are dark pools?

A term that refers to the trading volumes created by institutional orders, which are unavailable to the public. The bulk of dark pool liquidity is represented by block trades facilitated outside of the central exchanges. These are secretive electronic trading networks matching buyers and sellers anonymously.

The dark pool gets its name because details of these trades are concealed from the public. Some traders that use a strategy based on liquidity, feel that dark pool liquidity should be made public to all traders. They are becoming increasingly popular, as large institutional investors look for ways to trade blocks of stock without triggering ripples in the share price, as can happen on traditional stock markets.

Forty-two such US dark pool trading networks (June 2008) are completing for orders, up from seven dark pools five years ago and they account for about 10 percent of daily trading – up from one percent in 2003 according to the Tabb Group, a Massachusetts research firm. The largest pool operators include **Liquidnet Holdings Inc.** and **Posit**, owned by Investment Technology Group Inc.

Dark pools grew relatively slowly in the 1980's and 1990's but securities firms and their clients are expected to direct about 20 percent of their stock orders to dark pools by 2010, according to the Boston consulting firm Aite Group LLC. Goldman Sachs Group Inc.'s **Sigma X** is the biggest brokerage-owned pool followed by Credit Suisse **CrossFinder**.

Dark pool aggregators attempt to offer institutional investors a one-stop shop linking to other dark pools, much like Internet search engines. **One-pipe**, a recently launched aggregator provide access to more than 25 dark pools. Liquidnet's **H2O** dark pool is open to outside orders, although most brokerages with dark pools provide access to other pools, though they usually attempt to cross orders within their own systems first.

Algorithmic Trading or "Algo" Trading

This is a trading system sent by broker/dealers to the exchange that utilizes very advanced mathematical models for making share transaction decisions. The strict rules built into the model attempt to determine the optimal time for an order to be placed that will cause the least amount of impact on a stock's price. Large blocks of shares (referred to as the "parent") are usually "sliced" by dividing the large share block into smaller lots (referred to as the "child" orders) and allowing the complex algorithms to decide when the smaller blocks are to be purchased or sold.

The use of algorithmic trading is most commonly used by large institutional investors due to the large amount of shares they transact every day. Complex algorithms allow these investors to obtain the best possible price without significantly affecting the stock's price and increasing purchasing costs.

For example, a big pension fund wants to buy **150,000 shares of Company X**, but it does not want potential sellers and rival investors to know that they are in the market for such a big block of shares. Instead of placing one huge order, the fund can use computerized algorithmic trading, which will split up the “parent” order into smaller “child” orders.

There are two types of algo strategies:

1. Time-weighted Average Price

The simplest type of trading algorithm as it divides the parent order for 150,000 shares equally into 15 child orders of 10,000 shares each, executed with set time intervals over the course of several hours or days.

2. Volume-weighted Average Price

This divides the parent order into child order, but their sizes vary based on the historical average volume of trading of Company X’s shares at a specific time. This is the most popular type of trading algorithm.

Iceberg Order

An Iceberg Order is a specific order type/feature that a Stock Exchange offers to large participants, such as institutional investors, who need to buy and sell large amounts of securities for their portfolios. This feature involves the slicing of a large share order into smaller orders by algorithmic strategies. The order has to reside at the Exchange and it is no longer controlled by the executing broker. The Exchange’s iceberg feature only makes visible a small portion of the total order (“tip of the iceberg”) to the market and “refreshes” the visible order volume automatically, from the reserve/hidden portion when the visible portion is filled. By only releasing smaller increments of an order to the marketplace as visible orders, market impact of the underlying/hidden larger order is reduced.

Lot

In general, any group of goods or services making up a transaction. In the financial markets, a lot represents the standardized quantity of a financial instrument as set out by an exchange or similar regulatory body. For exchange-traded securities, a lot may represent the minimum quantity of that security that may be traded.

In terms of stocks, the lot is the number of shares you purchase in one transaction. In terms of options, a lot represents the number of contracts contained in one derivative security.

The concept of lots allows the financial markets to standardize price quotes. For example, equity options are priced such that each contract (or Board Lot) represents exercise rights for 100 underlying shares of common stock. With such standardization, investors always know exactly how many units they are buying with each contract and can easily assess what price per unit they are paying.