Tuesday, October 27. 2009
Posted by Karl Denninger in Regulatory at 08:13

Goldman's Dissembling (Dark Pools .et.al.)

Now comes Goldman with yet another pack of misdirection: (http://www.bloomberg.com/apps/news?pid=20601087&sid=ax4InQgscKws)

> Goldman told the Securities and Exchange Commission that computer-driven trading and an increase in stock transactions that occur off public exchanges has reduced consumer costs, increased competition and brought more liquidity to markets.
>
> “The investing community (especially retail) has benefited from the evolving market structure and industry competition,” Goldman Sachs said in a summary of the 55-page report submitted to the agency.

You have to love the general gist of this thing.

Let's break down what's really going on here, because it is both instructive and, in my opinion, necessary.

Dark pools and High Frequency Trading reduce transparency. The argument raised by Goldman and others is that these venues "improve price" for retail investors (and others), such as mutual funds (held by many retail investors.) The problem is that this is the wrong metric to apply.

Trading in *established* stocks is in fact a *negative sum game*. That is, for every share I get a "better price" on as a buyer, *the seller gets a lower price*. Worse, since there there are commissions and fees involved in all transactions, *the net effect of each trade is to dilute the total capital base in the system.*

An example will serve to show this:

$1,100 in total money in the system.
100 shares @ $10 "quoted".
Taxes, commissions and exchange fees of 1% of the transaction.

The buyer and seller transact all 100 shares. There is now $1,090 in total money (the other $10 has been siphoned off in commissions and fees.)

Do it again. There is now $1,080 (another $10 has been siphoned off.)

Perform 10 transactions and oops - there isn't enough money to transact an 11th time.

Now here's the rub - the amount of "spread" that the market maker, which would be Goldman (among many others) can make *is entirely dependent on the ability to hide the actual bid and offer by real investors!*

That is, let's assume that of the $10 in commissions and fees Goldman gets as a straight commission half of it. The rest is exchange fees and taxes. That is, off those 10 trades Goldman would make $50, the government would get perhaps $10 in taxes, and the exchanges would get the other $40 split among them in various service charges and such.

But what if the seller was willing to sell at $9.90, not $10, and yet that was in a "dark pool"? That is, the buyer of those 100 shares saw only the $10 price on the public exchange, and not the $9.90 offer in the dark pool?

Well now Goldman could buy those shares for $9.90 **and immediately sell them to the willing buyer for $10**.

Suddenly their $10 "commission" turns into $20 - **a doubling of their profit on the trade**, with essentially zero risk, since they will only execute this trade **if** they see both a bid at $10 and the "dark" (invisible to the retail investor) offer for $9.90.

The argument is often made that institutional investors would "dramatically" move the market with their entries or exits if they were required to be published on the exchanges in real-time.

Well, yes. And? Exactly why is this bad? *Is not the price of a security supposed to reflect the supply and demand for that security?*

Remember that for every buyer there is a seller, and for every seller (even if the seller is selling short!) there is a buyer. **Each and every trade that "advantages" one person through obfuscation and hiding of information disadvantages someone else by the exact same amount of money, <u>and further allows someone to skim off a piece of the transaction without being detected</u>**.

Goldman's position on this is entirely self-serving. They not only earn fees by operating one of these "dark pools" they also are given the opportunity to exploit the hidden nature of price to skim off part of the transaction stream for their own benefit. **That money always comes from one of the two parties - the actual buyer or seller - and if the "retail buyer" on one side benefits <u>the retail seller on the other side is getting screwed</u>**.

All "Dark Pools" and other means of gaming the system - that is, asymmetrical information - are without exception working **against** transparency and open markets. Ever since the markets went to "pennies" the market makers and brokers have been trying to find ways to skim that 1/8th or 1/16th they used to "earn" off the spread in transactions that was formerly theirs as a consequence of an enforced differential between bid and offer.

There is no free lunch, and Goldman's argument that retail investors are "helped" or "benefit" from dark pools and other means of obscuring price discovery is a flat-out lie.

The truth is that **some** retail investors "benefit" while others are screwed **in an exactly equal amount**, while at the same time the big broker-dealers exploit the hiding of information to skim off pieces of the transaction stream that radically increase their profits.

On-balance this is of net DETRIMENT to market participants, as the increase in skimming, whether through fees or exploiting the hidden nature of bids and offers, <u>always must come from one of the participants in the market, as for each buyer there is a seller and vice-versa</u>.

There is no free lunch.