

HFT Bashing

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HFT bashing by politicians and the media seems to be locked into a self-reinforcing cycle. The media cites growing concerns amongst politicians and public officials who in turn point to the media as evidence of public concern warranting intervention.

There is lots of woolly thinking that ought to be challenged:

- Recent suggestions that medium-term volatility in asset prices relative to underlying fundamentals is attributable to HFT are nonsense. By the most commonly accepted definition, HFT firms end each day (if not each minute) with no positions, so they cannot affect inter-day supply and demand unless their presence is precluding other classes of long term liquidity-supplying investors from participating in markets. If the medium-term volatility is growing, so are the opportunities for such contrarian investors, and it's hard to see how HFT would be keeping them away.
- Allegations that HFTs caused the May 6th flash crash by 'withdrawing their liquidity' are inconsistent with arguments that during normal market times the liquidity they provide is 'ethereal'.
- Talk of "growing evidence" that HFT is bad is too often just a reference to the clamouring of market participants with a particular vested interest or to the circus of media coverage. Indeed, the only [empirical study](#) I'm aware of seems to contradict most of the popular arguments levelled against HFT. It's encouraging to hear that the UK Treasury is commissioning an independent study by one of its economists.
- The fact that HFT firms are profitable (although less so of late according to the published results of several large players) does not necessarily mean that normal investors are losing out. It may be that HFT firms have supplanted traditional market makers and specialists and are providing the market with liquidity at lower cost than was previously the case.

And yet, despite the lack of coherent argument or empirical evidence thus far that HFT is detrimental, the debate seems to be progressing inexorably towards the adoption of measures to forcibly constrain HFT.

Clearly I'm un-persuaded that forcibly constraining HFT will improve market quality or benefit long-term investors, but intellectual curiosity compels me to consider some of the measures being recommended (usually by politicians) as a way to limit HFT participation in our public markets:

- A proposed "minimum quote duration" would be counterproductive (by which I mean idiotic). It misses the point that not all HFT is 'passive' by nature – there are plenty of HFT firms whose trading flow is entirely 'aggressive'. A minimum quote duration would allow aggressive HFT firms to systematically exploit brokers (and their investor clients) who would be unable to adjust/cancel their orders in response to price movements in other related instruments.
- Rationing orders or capping the "order-to-trade ratio" of individual HFT firms might well reduce the number of orders/quotes each individual firm generates – but the medium term impact is likely to be the emergence of more HFT firms. If there are profitable strategies that

individual firms are prevented from executing, others will eventually discover those strategies.

- Imposing a tax on order messages or cancellations “to cover the cost of market infrastructure” seems somewhat draconian. Is it appropriate for politicians to tell commercial companies they must charge more for a service?
 - In the US context, where there is a centrally funded consolidated quote system (which seems increasingly obsolete), wouldn't it be better to start by reforming the problematic formula that defines how consolidated quote data revenues are shared amongst markets (and then their participants) in relation to the number of quotes and trades generated (and which arguably creates commercial incentives to update quotes more frequently)?
 - In Europe, where regulators already worry that broker crossing networks and MTF dark pools might undermine price formation in lit markets, would introducing additional costs to provide liquidity in lit markets make sense? If the goal is to drive more liquidity towards the central, lit markets – is a new tax on their use the optimal way to achieve it?
- The (apparently popular) suggestion that “market makers” should be subject to “obligations” to provide liquidity in times of market stress doesn't appear to be grounded in reality.
 - Most European equity markets no longer have a formal market-maker designation – so rulebooks would need to be changed to establish which firms would be burdened by these new obligations.
 - No firm would take on an obligation to lose money (for that is exactly what is required to stabilise markets in times of stress) without being offered some counterbalancing privileges. Given MiFIDs emphasis on the “fair and non-discriminatory treatment” of all participants by exchanges and MTFs, should we welcome the creation of a privileged elite amongst market participants?
 - The reality is that the economics of liquidity provision have changed dramatically. Traditional market-making no longer exists because it ceased to be profitable. Given the competitive nature of HFT (many firms say that a typical strategy has a “shelf life” of only a few weeks), it's unlikely that they have the scope to absorb the losses required by new obligations if they're to be in any way effective. It just won't work without sufficient “incentives” – which takes me back to the dangers of creating a privileged few.
 - It won't work anyway. The benefits are illusory. No trading firm would sign up to the potential for unlimited losses – they'll always want an “out” in extreme cases. For example, how could they be compelled to continue supplying liquidity if there's a failure by exchanges to process orders or publish data in a timely fashion (as apparently happened on May 6th)?
- Suggesting that all markets “synchronise their market data output” so as to prevent latency arbitrage is a total nonsense that would either require us to suspend the laws of physics or mandate all markets and all participants to operate from a single geographic location. In a technology enabled and geographically dispersed world there is no “single NBBO/EBBO” – it depends where you are relative to the different market centres.

- Significantly increasing tick sizes would reduce the potential for client orders to be “stepped ahead of” at marginal cost. There would potentially be more liquidity at each price point, and thus stronger incentives to leave quotes live for longer (so as to reach the front of the queue). The minimum hurdles for a strategy to be profitable would be larger, and hence there would presumably be less HFT. This sounds like a viable approach, but unlike the other suggestions, the inherent costs are more obvious:
 - Spreads would be wider, resulting in higher trading costs for all market participants and for retail investors in particular (they typically submit marketable orders).
 - Wider spreads would increase the opportunity for brokers to offer clients price improvement via their internalisation services (BCNs, SIs) or via price-referencing midpoint MTFs – potentially resulting in more volume migrating away from lit markets.

So there’s no free lunch - surprise, surprise.

I eagerly await the conclusions of the Treasury’s study. And if the conclusion is that HFT *is* detrimental to market quality, I expect a lively debate about what to do about it. In the meantime, I expect that regulators will prioritise the prevention of another flash crash – and so expect (and support) further developments around market-wide volatility interruptions.

We invite feedback from brokers, competitors, regulators and institutional investors on our approach and our views.

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