

Slow down, you move too fast...

June 10th 2010

Before tackling some of the potential downsides, here's why speed and capacity are important:

- Market confidence suffers most when participants worry that they cannot trust the prices they see, or that they have lost control of their orders. Capacity and speed are essential to maintaining the confidence of investors, without which, liquidity suddenly evaporates (as it did in US markets on May 6th).
- The guarantee that markets will be highly responsive, and that an order can be amended or cancelled at any time, gives participants the confidence to expose limit orders that they might otherwise withhold from the market.
- The ability to execute instantaneously across multiple markets, instruments and asset classes leads to less risk for arbitrageurs, resulting in greater market efficiency of correlated assets. This reduces hedging costs and encourages liquidity provision and capital commitment.
- Markets with inadequate capacity or throughput reject orders at busy times (either implicitly or explicitly), reducing the liquidity that might otherwise be available just when it's needed the most.

For the above reasons, greater speed and capacity drive narrower spreads, which reduce overall transaction costs, improve overall investment returns, and help companies raise capital more cheaply (helping the real economy grow).

But what about *relative* speed and *relative* costs – are long term investors being systematically disadvantaged by those trading faster and at higher frequency? Do faster markets benefit one group of participants more than, or even at the expense of, others?

I think there's irrefutable evidence that competition amongst markets and amongst electronic market makers has resulted in a dramatic narrowing of spreads. Unambiguously, tighter spreads mean improved execution quality for retail orders (the majority of which are marketable). So it's hard to think of the 'amateur' market participants as victims in our new competitive markets.

What about institutional investors with large orders? Are market professionals the victims?

- **Would markets be better without electronic market making (EMM) firms?**
No. We know exactly what markets look like when EMM firms either cannot or choose not to participate. EMM firms operate with extremely low margins, and are incredibly sensitive to risk – so they're the first to be forced out of the market when systems slow down. May 6th was instructive – when EMMs back away, volatility increases dangerously.
- **Is the liquidity provided by EMM firms 'real' or 'ephemeral'? If you take liquidity from an EMM that immediately unwinds for a profit, would you have been better off not taking their liquidity in the first place? If they end the day with a flat book, but have made money, has that come out of the institution's pocket?**
In price-time markets, you always get the best available price at the time. Liquidity offered by EMM firms is just as real as that offered by any other participant – except it's often more competitively priced. And if the EMM firm with which you trade is able to profitably unwind that risk in other stocks or asset classes, rather than by directly covering the position, then you've accessed liquidity that wouldn't have otherwise been available. Their profit is not necessarily your loss.

- **Is it fair that some participants invest in the fastest technology and most sophisticated algorithms, and co-locate their systems beside exchanges, potentially allowing them to react more quickly than other participants?**

Fair or not, it's absurd to imagine that we can effectively legislate against profit-maximising behaviour by market participants. If co-location was prohibited, then firms will instead congregate in data-centres adjacent to the markets. And there's no way to ensure that all participants receive all data simultaneously – even if we had a consolidated EBBO (which I've argued against previously). To borrow a phrase from politics – it's about “equality of opportunity” – we have to recognize how much fairer and more efficient markets are now we have a level playing field with many firms competing to add or remove liquidity than they were with ‘designated’ specialists or market makers (who enjoyed special privileges).

- **Do some automated trading firms exacerbate volatility or engage in ‘momentum ignition’ by stepping ahead of large orders, forcing them to revise their buys upwards and sells downwards?**

Here's the rub. Efficient markets are supposed to ensure that the price “reflects all available information” – and automated trading firms specialise in recycling the information represented by market data back into the price. If the market is aware of a large buying or selling interest, it's only natural that prices move – with “market impact” and “market efficiency” being closely related. For such trading strategies to be viable, automated traders rely on the propensity of brokers executing client orders to “chase” a stock up or down regardless of “fair value”. Whilst this all within the rules (let's trust that market surveillance is effective in spotting rule-breaking), it can be frustrating and costly for a trader who sees their order being stepped ahead of.

So there might be some scenarios in which automated traders take advantage of institutional flow – but what, if anything should we do about it? Is it a matter of brokers becoming more sophisticated, or clients changing their trading style? Or do we need regulatory intervention to protect one category of professional participant from another?

Two thoughts spring to mind:

- Just as most financial professionals oppose protectionism in the real economy, we shouldn't ask or expect regulators to make financial markets ‘safe’. It's the competition amongst market participants that drives market efficiency forwards and encourages brokers to invest in smarter trading strategies.
- Any regulatory ‘cure’ (such as a transaction tax, or other constraints on trading activities) would be far worse than the problem they're trying to fix – ultimately sapping liquidity from markets and driving spreads and volatility higher, to the detriment of institutional and retail participants alike.

The real conclusion to draw is that transparent price-time markets aren't ideal for every order, and so brokers and market operators need the flexibility to offer investors alternative solutions that allow them to access liquidity in the manner most appropriate to the order in question. Given individual investor's preference to trade with less market impact, post-trade transparency is essential to ensure these alternatives still support efficient price formation.

[We invite feedback from brokers, competitors, regulators and institutional investors on our approach and our views.](#)

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