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Post 'Flash,' Where Trading Reform Is Headed

From the Experts

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In “Flash Boys: A Wall Street Revolt,” Michael Lewis contends that High Frequency Traders (HFT) have created a stock market that is rigged. He argues that they pick off large buy-side orders, effectively front-running retail customers. Lewis also claims HFTs use technology to get unfair speed advantages. These charges have led to investigations by both the market regulators—the Securities and Exchange Commission and the Commodity Futures Trading Commission—as well as the Federal Bureau of Investigation, the U.S. Department of Justice and the Office of the New York Attorney General.

In our view, Lewis's book focuses on the wrong things. Charges of a rigged market and front-running sell books, but they do not square with a market where execution is arguably cheaper than it has ever been, particularly for Lewis' supposed victims—retail customers. Similarly, “revelations” of innovations to increase trading speed are less potent when you realize that they're largely about HFTs gaining an advantage over other HFTs.

There are, however, real issues in our existing market infrastructure that require reform. While they're not as flashy as front-running, we expect that over time the more sensational aspects of the book will fade and regulators will focus on four issues: (1) bespoke order types; (2) maker-taker pricing; (3) arbitraging data feeds; and (4) risk controls.

Order types. Currently, the bulk of HFT volumes are executed with special order types specifically designed by HFTs and exchanges. Critics contend that many of these order types have the effect of circumventing some of the requirements introduced by the order handling rules and Reg NMS. Examples of such bespoke order types include orders that will not interact with orders smaller than themselves, and dark orders—orders fully hidden on exchanges from other traders and their algorithms.

There are two key issues that regulators are likely to focus on. First, do these new order types provide any benefits to price discovery? Because exchanges can compete on order types, some participants may argue that competition among exchanges will sort out which order types are beneficial. Regulators, however, may feel the need to set the parameters of that competition. Further, if exchanges are to compete on order types, how does that affect intermarket price priority, the National Best Bid Offer (NBBO), and rule 611 compliance? If we're going to allow some of these order types, do we need to rethink how we conceptualize NBBO?

Second, and more important, do exchanges need to provide more disclosure regarding order types? A number of market participants have complained that they were unaware of the existence of bespoke order types. Many industry critics have been arguing about the unfairness of these order types for some time. If these bespoke orders are not fully disclosed, does that raise the issue of collusion? What duties of disclosure does an exchange have? Is there potential liability for a failure to disclose? Regulators will need to provide some guidance.

Maker-Taker. Criticisms of maker-taker are not a new topic . Jeff Sprecher, chairman and CEO of the IntercontinentalExchange Group Inc., suggested reforms several months ago. The system, by which traders who "hit" a quote pay a small fee and traders whose quotes are "lifted" receive a slightly smaller fee, with the exchange pocketing the difference, was initially a way for exchanges to attract liquidity. Some traders have pioneered strategies designed to profit off this rebate system. While the fees and rebates are extremely small, over millions of trades it adds up. The SEC has for some time been considering trial reforms of maker-taker and we would expect to see them in the not too distant future.

Data Feeds. While Lewis complains about the race for speed, the real issue may actually be data feed arbitrage. Many trading strategies seek to take advantage of differences between quotes on the Securities Information Processor (SIP) feeds, which are usually stale, and their own, faster, direct feeds. Because SIP feeds are a fundamental component of the NMS framework and many functions of NMS are effectively benchmarked to them, outages can create significant disruptions and distortions can lead to mispricing. SIP feeds may not actually reflect where the market is and there is little incentive for private sector actors to invest in improving them. Thus, we believe regulators may coalesce around various strategies (and investments) to improve the performance and reliability of the SIP feeds.

Risk Controls. Last, though little mentioned in Lewis's book, issues of market stability continue to trouble regulators. The flash crash and the collapse of Knight Capital were wake-up calls and regulators will likely continue to focus on pre-trade risk controls as a way to enhance market stability. In January the CFTC published a concept release regarding risk controls of automated trading systems and asked for public comments. To date, proposals have focused on current best practices, such as order limits, fat finger limits, stop limits and position limits, all of which are technologically feasible. However, the renewed attention and concern regarding high frequency trading may create interest in moving toward something like real time pre-trade credit checks—i.e., verifying that a trader (and/or his clearing firm) have not exceeded their credit limits before allowing a trade to be executed. Forms of such pre-trade credit checks exist in the swap markets (CFTC rules 1.73 and 1.74), but scaling up this sort of protocol to the futures and equity markets would be technologically very difficult.

Lewis's book, and its charged accusations, have generated intense interest. But we believe that regulators will eventually return their focus to the four issues identified above. While not as headline-grabbing as claims that the market is rigged or that HFTs are getting away with fraud, these issues help ensure that the markets function and that they operate efficiently.

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