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'Secrets' behind high frequency trading

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Fiery debates over whether high frequency trading (HFT) has rigged the markets occupied media headlines in the past few days, but market participants, scholars and regulators have still not found a solution, with expanded investigations underway.
Michael Lewis, the author of the book "Flash Boys: A Wall Street Revolt", published in March, argued the market was rigged in favor of high frequency traders, who front-run other institutional traders to access orders placed by investors within a fraction of a millisecond.

Even the tiny fraction of a millisecond is valuable. According to Lewis, high frequency traders are able to identify investors' intentions to buy stocks and execute orders ahead of those investors and sell back to them at a higher price.

UNFAIR ADVANTAGE

"Arguably, that's an unfair advantage" because they are able to look at things in probably a little more clear detail and are able to see bids and offers, says Mark Newton, chief technical analyst at Greywolf Execution Partners Inc..

"But I don't want to characterize that as being bad, whatsoever. I think it's a minor glitch, something that needs to be fixed," Newton said Wednesday.

Kenneth Polcari, director of the NYSE floor division at O'Neil Securities in New York, told Xinhua all the debates stirred up by the book and the investigation into HFT "are actually very good in the sense that it brings to light and to the surface the problems of the current market structure, which then float down to HFT."

"It's not a level playing field at the moment because of the differences in speed," Polcari said.

Polcari said he did not think the market was "rigged" but rather "broken." "Some people would assume because it's broken then it's rigged. I don't believe that. I don't think it's rigged at all. I think it's broken, which then allows predatory behavior, which makes it appear it's rigged."

The market had loopholes, which allowed predatory high frequency traders to take advantage, Polcari added. "That's why it's broken and needs to be fixed."

However, "fairness is a subjective word," argued Christopher Ivey, chief executive officer at EquaMetrics Inc., a financial software and systems developer that specializes in algorithmic trading applications.

The stock market is not necessarily just to trade companies; it is more of a liquidity pool, Ivey said. "So having a competitive advantage in a fair market arena ... I don't think it's unfair in a field where you can trade," he said.

Bernard S. Donefer, adjunct associate professor of Information Systems at New York University's Stern School of Business, said the market was "absolutely not" rigged by HFT as no one or any study so far has found ample evidence HFT traders were doing something inappropriate or illegal.

PROS AND CONS

High frequency trading has "as equally as many positives as there are negatives," Newton said. "I wouldn't say it's wrong or evil. I think there needs to be some changes probably."

Donefer said HFT could increase liquidity and lower costs, which "benefited the entire market."

According to the professor, in one type of HFT, market makers continuously update their prices to be the first with the best price, so investors who want to buy stock can execute orders quickly and prefer to trade with HFT traders.

Newton said it was "a far too big an over-reach" to say HFT was bad and should be eliminated, nor to say the game was rigged.

"The statement saying that Wall Street is rigged and I can't make money is exactly the wrong idea, particularly at a time when the Street itself is really trying to rebuild its image, trust and confidence after a couple of huge bear markets over the last 15 years and obviously the calamity that happened in 2008," he said.

Newton suggested people should educate themselves about the improvements made in recent years and why it was cheaper for them to trade than ever before and the equity was better than ever before.

However, Newton said, the negatives of HFT were that people who tried to buy in the market sometimes might not get exactly what they wanted. So it was up to them to figure out the best price.

Moreover, Ivey said HFT could hurt a company's stock performance and growth.

HFT uses sophisticated technological tools and computer algorithms to rapidly trade stocks and trades more than all retail investors combined. Thus, if a certain algorithm short-sells a company's stock at a level that it believes should not go higher whereas the general market believes it could go higher and buy it, then the HFT's short-selling "can obviously negatively affect the general market capital and corporate health of the company that's been traded," Ivey explained.

"I don't necessarily think we should stop at the moment. But I will definitely admit that there can be negative effects on a company's stock performance by these things," he said.

REGULATION CONUNDRUM

Governments of many countries face the conundrum of regulating HFT as they have not been able to prove categorically HFT is inappropriate.

"The U.S. Securities and Exchange Commission has been talking about this for years, but hasn't done anything," New York University's Donefer said.

Donefer said the British, Australian and German governments had all conducted studies on HFT, and all three studies said they were unable to find real problems with HFT, but rather found real benefits.

The professor said it was complaints about HFT by people who lost money in the stock market that propelled governments and regulators to investigate.

Following the release of Lewis' "Flash Boys," the U.S. Federal Bureau of Investigation told media on March 31 it was actively investigating possible abuses involving HFT. The FBI launched the High-Speed Trading Initiative about a year ago but the probe is still in its early stage.

"I think they will have a hard time proving the HFT is anything but legal and normal," Ivey said.

Moreover, Ivey added, it would raise a big ethical question in the long run: what was the point of a stock market and why were we all trading on it?