



High Frequency Trading: Red Flags and Drug Addiction

By Joe Saluzzi, Themis Trading
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I attended a roundtable discussion yesterday morning produced by STANY titled "High Frequency Trading: The New World Order". In case you are not familiar with the subject, high frequency trading is the hottest thing in the equity market right now. Over 60% of equity volume comes from the high frequency traders (HFT). Basically, HFT's are computers that execute trades with extremely low latency. They live in a world of milliseconds. If your computer takes more than 50 milliseconds to execute, then you are a dinosaur in this business. The panel at this roundtable was comprised of 2 brokers that sponsor access to HFT's, one exchange rep that courts the HFT's and one option market representative. Here are my notes:

- 1) The high frequency trading business is extremely profitable. Based on the smugness and the smiles on the faces of the panel members, I could tell they were killing it. They reminded me of the "SOES Bandits" from the early '90's. But I sensed that they realized that their role in the market place was being squeezed and they were just trying to max out their profit before the game ended.
- 2) HFT's claim to be market makers and they claim that the liquidity they add to the market has lowered volatility and helped narrow spreads. But the problem here is unlike a traditional market maker, they have no requirements. No minimum size to display, no minimum time to display a quote and no capital commitment to a client.
- 3) There are very low barriers to entry to becoming a HFT. All you need to do is to become a client of a sponsoring broker. This will eventually cause market saturation and reduced HFT margins. Only the biggest, fastest computers will be making money consistently.
- 4) The HFT's tried to prove that they add value to the market by referencing the SEC's ban on short selling in 19 financial stocks last year. They noted studies that showed after this was enacted spreads widened by 40% and volumes decreased substantially. They said that since HFT's couldn't properly arbitrage the stocks, they simply did not participate. BIG RED FLAG should go up here. These HFT's can simply walk away from the market when the rules don't suit them. So what happens if the SEC enacts the uptick rule again or what happens if a major event causes turmoil in the market? Will these HFT's simply shut down their computers and walk away since their model has been corrupted. What happens to that 60% of the volume that they now control? Where will all that LIQUIDITY that they claim they provide go when the market doesn't suit them? A major vacuum will be formed in the market as multiple parties run for a much smaller than expected exit.
- 5) The exchanges actively court the HFT order flow since it is extremely profitable for them. They are like drug dealers trying to control their turf and the HFT's are the drug addicts. Making so much money with so little risk is extremely addicting.
- 6) I must commend the HFT's for one thing: they constantly were talking about risk to the system. They spoke of "naked access" (nice term) and how a rogue trader that comes unfettered through a brokers' system had potential to inflict major damage on the market. They spoke about the fact that the exchanges have no idea of who is on the other side of the trade since they are coming through sponsored brokers. They spoke of the lack of risk controls that are currently in place. Remind anybody of some recent market occurrences?
Our equity market is being controlled by machines that are nothing more than two bit, SOES bandits. They cloak themselves under the mantra of liquidity providers but they are really just locusts and are feeding off the equity market until it doesn't suit them anymore. Once their profit margins are squeezed off almost zero, they are likely just to move on to a new market. But what damage would they have done? We will be left with a shell of a market that is used to being led around by computers. Real people and real capital are a scarce resource in today's market.

