

Why Institutional Investors Should Be Concerned About High Frequency Traders

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It is now generally understood that high frequency traders (HFTs) are dominating the equity market, generating as much as 70% of the volume.

HFTs are computerized trading programs that make money two ways, in general. They offer bids in such a way so as to make tiny amounts of money from per share liquidity rebates provided by the exchanges. Or they make tiny per share long or short profits. While this might sound like small change, HFTs collectively execute billions of shares a day, making it an extremely profitable business.

Why should institutional or retail investors care? After all, aren't HFTs adding liquidity? That's what they and the exchanges, who court their business, say.

There's a lot to worry about.

- 1. HFTs provide low quality liquidity.*

In the old days, when NYSE specialists or NASDAQ market makers added liquidity, they were required to maintain a fair and orderly market, and to post a quote that was part of the National Best Bid and Offer a minimum percentage of time. HFTs have no such requirements. They have no minimum shares to provide nor do they have a minimum quote time. And they could turn off their liquidity at any time. When an HFT computer spots a real order, the HFT is not likely to go against it and take the other side. The institution is then faced with a very tough stock to trade.

- 2. HFT volume can generate false trading signals.*

This can cause other investors to buy at a higher price, or sell at a lower price, than they would otherwise. A spike in HFT volume can cause an institutional algorithm order based on a percentage of volume to be too aggressive. A spike can attract momentum investors, further exaggerating price moves. Seeing such a spike, options traders can start to build positions, which, in turn, can attract risk arbitrage traders who believe there's potential news that could affect the stock.

- 3. HFT computer servers are faster than other trading systems.*

Because most HFT servers are co-located at exchanges, they can beat out institutional or retail orders, causing them to pay more or sell for less than they should have for a stock.

Then there are the "what if" problems that could be created by HFTs.

1. *What if a regulation like the uptick rule were enacted?*

Volumes could implode and stocks that appeared highly liquid could become extremely difficult to trade with wide spreads and no depth in the quote.

2. *What if a “rogue” algorithm entered the market?*

Many HFTs are hedge funds that enter their orders into the market through a “sponsored access” arrangement with a broker. Many of these arrangements do not have any pre-trade risk controls since these clients demand the fastest speed. Due to the fully electronic nature of the equity markets today, one keypunch error could wreak havoc. Nothing would be able to stop a market destroying order once the button was pressed.

Gives new meaning to the term “mutually assured destruction?”

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