

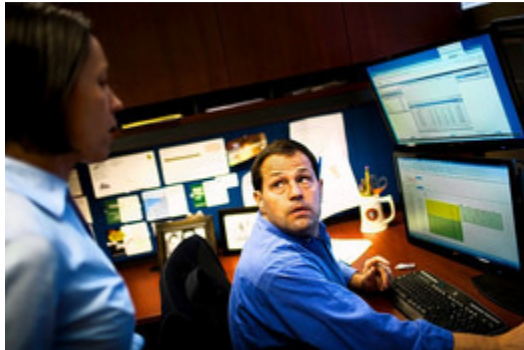
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Fast Traders' New Edge

Investment Firms Grab Stock Data First, and Use It Seconds Before Others

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Some fast-moving computer-driven investment firms are getting an edge by trading on market data before it gets to other investors, according to market players and researchers who have studied the trading.



Scott Lewis for The Wall Street Journal

FIGHTING BACK: Rich Gates, right, with trader Christine DeAngelo at TFS Capital in West Chester, Pa., sees 'unusually suspicious' activity.

The firms gain that advantage by buying data from stock exchanges and feeding it into supercomputers that calculate stock prices a fraction of a second before most other investors see the numbers. That lets these traders shave pennies per share from trades, which when multiplied by thousands of trades can earn the firms big profits.

Critics call the practice the modern day equivalent of looking at share prices listed in tomorrow's newspaper stock tables today.

"It is a rigged game," **Sal Arnuk**, co-founder of brokerage firm **Themis Trading**, said Wednesday at a Securities and Exchange Commission roundtable discussion in Washington, D.C., referring to the trading activity, which some call "latency arbitrage."

While legal, the practice pushes the envelope of what is fair, critics say, and raises questions about the advantages some fast-moving traders are gaining in the market.

The SEC roundtable convened executives from trading centers and firms across Wall Street as the agency continues to probe high-frequency trading and the growth of dark pools, trading venues where trades take place away from the main exchanges.

High-frequency trading has come under greater scrutiny since the May 6 "flash crash," when some high-frequency firms along with a number of other active traders withdrew from the market, arguably exacerbating the stocks' swift downdraft that day.

High-speed trading, now estimated to account for about two-thirds of U.S. stock market volume, takes many forms, some entirely proper. Defenders say it reduces trading costs for all investors by adding volume to the market. Latency arbitrage is a type of trading that relies on ultrahigh speeds; it's not clear which firms engage in it or how pervasive it is.

Some firms pay tens of thousands of dollars a year to individual exchanges for premium access to their price feeds, industry players and exchanges say.

The SEC, in a broad review of market structure earlier this year, said information from trading-center data feeds "can reach end-users faster than the consolidated data feeds."

The latency arbitrage trade aims to game the so-called national best bid and offer price on a stock, which sets the price most investors use to trade.

The ability to estimate price moves ahead of the national best bid and offer price, which is consolidated electronically from exchanges, can give traders an advantage of about 100 to 200 milliseconds over investors who use standard market tools, according to a November 2009 report on such trading activities by Jefferies & Co.

An advanced look at exchange data and order flow can provide firms "the ability to forecast future prices" and "make adjustments to their orders in the market or send new orders which are based on this information," the report found.

Some investors are searching for ways to protect themselves. Rich Gates, co-founder of TFS Capital LLC, started becoming concerned about latency arbitrage in early 2009 after a Wall Street bank pitched the trade to his firm.

In hundreds of tests, TFS has found that some of its trades were getting picked off by firms exploiting the time-delay wrinkle. That was costing the firm money.

To learn more, TFS, which manages about \$1.1 billion in mutual funds and hedge funds, devised a method to essentially bait firms into engaging in the trade. In effect, TFS proved that some traders were wise to a movement in a stock's price before it happened.

On a March afternoon, a TFS trader sent an order to a broker to buy shares of [Nordson](#) Corp., a maker of fluid dispensing equipment. The trader sent an instant message to the broker: "please route to broker pool #2," a request to send the order to a specific dark pool.

The trader told the broker not to pay a price higher than the midpoint between what buyers and sellers were offering, which at the time was \$70.49.

Several seconds after the dark pool order was placed, the market price didn't change. Then the TFS trader set a trap: he sent a separate order into the broader market to sell Nordson for a price that pushed the midpoint price down to \$70.47.

Almost immediately, TFS was sold Nordson for \$70.49—the old, higher midpoint—in broker pool No. 2, which didn't reflect the new sell order. TFS got stuck paying two cents more than it should have, suggesting that some seller knew the higher price was a good deal to nab quickly.

Such trades are "unusually suspicious," said Mr. Gates.

Most dark pool operators say they police investors for improper activities. Liquidnet, which runs a dark pool, had suspended 125 members through 2009 for suspicious trading since its launch in April 2001, the firm says.