High-Frequency Traders Ripping Off Investors, Michael Lewis Says
2014-03-31 04:01:00.9 GMT

By Nick Baker and Sam Mamudi

March 31 (Bloomberg) -- The U.S. stock market is rigged when high-frequency traders with advanced computers make tens of billions of dollars by jumping in front of investors, according to author Michael Lewis, who spent the past year researching the topic for his new book “Flash Boys.”

While speed traders’ strategies, developed over the past decade with help from exchanges, are legal, “it’s just nuts” that they’re allowed, Lewis said during an interview televised yesterday on CBS Corp.’s “60 Minutes.” The tactics are too complicated for individual investors to understand, he said.

“The United States stock market, the most iconic market in global capitalism, is rigged,” Lewis, whose books “Liar’s Poker” and “The Big Short” highlighted Wall Street excesses, said during the interview. The new book comes out today. “It’s crazy that it’s legal for some people to get advance news on prices and what investors are doing,” he said.

Everyone who owns equities is victimized by the practices, in which the fastest traders figure out which stocks investors plan to buy, purchase them first and then sell them back at a higher price, said Lewis, a columnist for Bloomberg View. To show how lucrative the tactics are, Lewis said a technology firm spent $300 million to build a line that would shave three milliseconds off the time it takes to communicate between New Jersey and Chicago, then leased it out to securities companies for $10 million each.

Industry Obsession

The author’s comments follow New York Attorney General Eric Schneiderman’s decision to investigate privileges marketed to professional traders that allow them to place their computers within feet of exchanges and buy access to faster data streams.
Officials at the U.S. Securities and Exchange Commission and Commodity Futures Trading Commission have also said market rules may need to be examined.

Lewis is adding his voice to a debate that has obsessed the securities industry for almost a decade while only periodically surfacing in public via events such as the May 2010 flash crash, in which the Dow Jones Industrial Average posted an almost 1,000 point loss. Previous books by the one-time Salomon Brothers Inc. trader have focused attention on everything from mortgage derivatives to baseball statistics and contributed to the outcry over the events leading to the 2008 financial crisis.

His latest target, high-frequency trading, comprises a diverse set of software-driven strategies that have spread from U.S. equity markets to most developed countries as computer power grew and regulators tried to break the grip of centralized exchanges. While the tactics vary, they usually employ super- fast computers to post and cancel orders at rates measured in thousandths or even millionths of a second to capture price discrepancies on more than 50 public and private venues that make up the American equities market.

Dominating Volume

High-frequency traders account for about half of share volume in the U.S., a statistic that shows their pervasiveness and hints at the obstacles faced by proposals to rein them in.

Exchanges rely on HFTs for profits as well as liquidity, with electronic market makers all but eliminating the old system of human floor traders who oversaw the buying and selling of equities. While critics such as Lewis see a Wall Street plot, proponents say the new system is faster and cheaper.

In the U.S., the biggest high-speed traders include Virtu Financial Inc., which filed in March to sell shares to the public. Bats Global Markets Inc., the Lenexa, Kansas-based equity exchange that merged with Direct Edge Holdings LLC this year, was founded by a high-frequency trader.

Book's Hero

"We believe Lewis's book can have a big impact on complex market-structure issues that have been simmering for years,"
Joe Saluzzi, co-head of equity trading at Themis Trading LLC and a frequent critic of the status quo in markets, said before the
"60 Minutes" interview was broadcast. "Hopefully this type of publicity will finally force regulators to take action on issues that they've been sitting on for way too long."

One of the heroes of Lewis's book is Brad Katsuyama, who left Royal Bank of Canada in 2012 to form a new market, IEX Group Inc., along with other former traders from the Toronto- based bank. David Einhorn's Greenlight Capital Inc. hedge fund invested in the platform, which started trading in October and was established to minimize the influence of predatory strategies, Goldman Sachs Group Inc. has endorsed IEX and is the venue's biggest broker.

Ticket Prices

IEX was established partly to address concern that technology advances and fragmentation have made the $22 trillion U.S. equity market too fast and opaque. The platform, a dark pool with ambitions to officially become an exchange, imposes a delay of 350 microseconds, or 350 millionths of a second, on orders -- enough to curb the fastest trading firms. IEX aims for greater transparency by making its trading rules available for public review, unlike some other electronic venues.

During his own interview with "60 Minutes," Katsuyama described how the stock market rips off investors. While still at Royal Bank, he noticed that prices seemed to move against him when he was trading.

"The best analogy I think is that your family wants to go to a concert," he said. "You go onto StubHub, there's four tickets all next to each other for 20 bucks each. You put in an order to buy four tickets, 20 bucks each and it says, ‘You’ve bought two tickets at 20 bucks each.’ And you go back and those same two seats that are sitting there have now gone up to $25.”

‘My Jaw’

Katsuyama concluded that his intentions became visible on some exchanges faster than others. The most fleet-footed traders could take advantage of that by submitting bids and offers on the slower markets.

Lewis said, “I spoke to dozens of investors, big investors, famous investors who said that, ‘When Brad Katsuyama came into my office and laid out to me how the market was rigged, my jaw hit the floor. I mean, I knew something was wrong. I just didn’t know what it was and no one had told us.’”

Eric Ryan, a spokesman for the New York Stock Exchange, and Nasdaq OMX Group Inc.’s Rob Madden declined to comment on Lewis.

“We completely disagree with allegations that the U.S. equity market is rigged,” Bats President Bill O’Brien said in an e-mail. “While we should never stop trying to improve our market structure, it is unfair and irresponsible to accuse people simply because they use technology and enhance competition. This has helped make our market the most competitive and liquid in the world, greatly benefiting individual investors.”

New York

New York’s Schneiderman is examining the sale of products and services that offer faster access to data and richer information on trades than is normally available to the public.

Wall Street banks and rapid-fire trading firms pay for these services, providing millions of dollars in quarterly sales to exchanges and helping ensure their markets are supplied with standing orders to buy and sell stocks.

Bloomberg LP, the parent of Bloomberg News, provides its clients with access to some proprietary exchange feeds.

The investigation threatens to disrupt a model that market regulators have permitted for years as high-speed trading and concerns about its influence have grown. Trading firms pay to place their systems in the same data centers as the exchanges, a practice known as co-location that lets them directly plug in their companies’ servers and shave millionths of a second off transactions.

High-frequency-trader Virtu publicly released its initial public offering filing in March. The New York-based market maker, which provides quotes in more than 10,000 securities and contracts on more than 210 venues in 30 countries, said it had turned a profit every day except one for five years. The company uses IEX.

CFTC Review

Virtu disclosed in the IPO filing that the U.S. Commodity Futures Trading Commission is looking into its trading from July 2011 to November 2013, examining its “participation in certain incentive programs offered by exchanges or venues,” according to the IPO filing. Virtu said it doesn’t believe it broke any laws or CFTC rules.

Chris Concannon, Virtu's president and chief operating officer, declined to comment before the "60 Minutes" broadcast, citing rules that prevent companies from speaking while planning IPOs.

Share volume totals show the transformation that high- frequency firms have wrought in American equity markets. While combined trading on the NYSE and Nasdaq rarely exceeded 2 billion shares in the 1990s, today it is regularly three times that in the U.S. About 6.05 billion shares changed hands on all U.S. exchanges in the last session, data compiled by Bloomberg show.

'Not Rigged'

Not everyone says speed trading is unfair.

"While there are bad actors in every industry, the game is not rigged in the favor of professional traders who employ HFT to execute their strategies," Peter Nabicht, senior adviser to the Modern Markets Initiative trade group and former chief technology officer at high-frequency-trading firm Allston Trading, wrote in an e-mail.

"Rather, they work hard to compete with each other to bring liquidity to the markets, benefiting average investors," he added. "Continued debate about the next evolution of market structure is needed and welcome, provided the debate is based on fact and resulting actions are reasoned, ensuring average investors continue to benefit from the transparency and efficiency enabled by inevitable technological advances."

Encouraging Trades

The practice of selling enhanced access to brokers accelerated as American exchanges evolved from member-owned firms amid a flurry of regulation and computer advances in the 1990s. Among other changes, the government-mandated compression of stock price increments to pennies from eighths and sixteenths of a dollar, a process known as decimalization, squeezed profits for market makers and specialists that had overseen stock trades.

Faced with the need to maintain liquidity on electronic platforms where profits were too fleeting for humans to capture, exchanges encouraged computerized firms to post orders for investors to trade against. Co-location and customized data feeds developed alongside the hodgepodge of fees and rebates that market operators use to keep speed traders coming back.

"Part of what you're seeing here is people not understanding it, because they either haven't taken the time or haven't dug in," Larry Leibowitz, the former chief operating officer of NYSE Euronext, said in a March 25 conference call with analysts arranged by Sandler O'Neill & Partners LP. "It's the responsibility of regulators to show leadership to show, 'We looked at these issues, and we think these are fair. These are areas we want to improve and fine tune.'"

Old Days

Market-maker privileges have always been a hallmark of equity trading, starting with the sale of seats on the floors of exchanges. LaBranche & Co., created in January 1924, went public in August 1999. In papers prepared for its IPO, LaBranche disclosed that it regularly turned about 71 percent of sales into profit before paying its managing directors. Earnings before that expense climbed at least 25 percent every year from
1995 through 1999.

Results like those, as well as concern that NYSE and Nasdaq were too powerful, helped spur reforms since 2000 such as decimalization and a broader overhaul known as Regulation NMS that was aimed at lowering barriers to trading. Through rules mandating that any order for stock be routed to whoever in the country was transmitting the best offer to buy or sell, regulators hoped competition among a much larger pool of de facto market makers would lower costs for investors.

Lower Fees

That happened. Buying 1,000 shares of AT&T before 1975 would have cost $800 in commissions, Charles Schwab, who founded discount brokerage Charles Schwab Corp., told the U.S. Senate in February 2000. That's roughly 100 times more than the fees paid by some retail stock-pickers today.

Federal regulators have asked for years whether new restrictions were needed. In February 2012, Daniel Hawke, the head of the SEC's market-abuse unit, said the agency was examining practices such as co-location and rebates that exchanges pay to spur transactions. Last year, the CFTC announced a review of speed trading and sought industry input.

SEC Commissioner Daniel Gallagher said on March 28 that individuals are concerned that high-frequency traders detract from fairness in the marketplace.

"The problem with high-frequency trading right now is that there's a perception that for the little guy, the markets aren't fair," Gallagher told CNBC during an interview. "That perception to me is a reality. It's something we need to address."

For Related News and Information:
RBC Joins Goldman Sachs Voicing Support for New Stock Market NSN N35GQY6S972A<GO> Einhorn Invested in New U.S. Market IEX, '60 Minutes' Says NSN N35Q7D6VDKI6 <GO> High-Speed Trading Faces New York Inquiry Into Fairness NSN N2NEY16S972M <GO> High-Frequency Traders Meet Nightmare on Elm Street With Nanex NSN MWU8SV6S972J <GO> Schneiderman Joins Einstein Pressuring High-Frequency Trades NSN N2SJ496VDKHS <GO> U.S. Robots Make Speedy Trades With Speedy Mistakes: QuickTake NSN MX96RU1ANZL1 <GO> Declawing Speed Traders Is Goal of Stock Market Revamp Proposal NSN N19ZUA6K50XZ <GO> News on market structure: NI MKST <GO>

To contact the reporters on this story:
Nick Baker in Chicago at +1-312-443-5942 or nbaker7@bloomberg.net; Sam Mamudi in New York at +1-212-617-1761 or smamudi@bloomberg.net To contact the editors responsible for this story:

Chris Nagi at +1-212-617-2179 or
chrisnagi@bloomberg.net
David Scheer