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A high-speed retreat keeps Goldman out of a tangle

By John Gapper

The rush into a business profitable for those with an edge has gone into reverse

What is Goldman Sachs up to? The bank has been behaving strangely this week. When Michael Lewis unveiled his book *Flash Boys: A Wall Street Revolt*, in which he alleged the equity market is “rigged” by high-frequency traders, the bank discreetly lent him support. Then it emerged that Goldman is leaving the New York Stock Exchange floor, selling Spear, Leeds & Kellogg, a broker it bought for $6.5bn in 2000.

This is the same Goldman that is one of the world’s biggest equity broking and trading firms; is accused by Lewis of letting its proprietary traders exploit its own “dark pool” private exchange; prides itself on being “long-term greedy” in pursuit of profit; and is probably the most politically connected investment bank on the planet.

Legend has it the British monarchy will fall if the ravens leave the Tower of London. When Goldman abandons the floor of the NYSE and shows more affection for IEX (the new equity exchange praised by Lewis) than for Sigma X (its own dark pool), I wonder about the health of high-frequency trading and the banks’ trading forums.

Goldman could be acting purely on principle, having had a Damascene conversion about the error of its ways. Without being rude, however, I think we can dismiss this possibility. That leaves two others: there is less money than there used to be in high-

frequency trading, and it thinks regulators could soon burst through the door. Given that Goldman is highly attuned to the ebb and flow of moneymaking opportunities and to how much Wall Street can get away with at any moment, these sound more plausible.

Equity trading has been through a revolution during the past decade, with Regulation NMS in the US and the Mifid directive in Europe starting an arms race of high-frequency competition. New exchanges and dark pools have proliferated, with floor traders and market makers replaced by software feeding high-speed orders through fibre-optic cables to exchanges.

That made the market more competitive, as regulators wanted. It also led to the speed rush described in *Flash Boys* – the laying of superfast cables and "co-location" of traders' equipment in electronic exchanges in order to be the first to react to market movements. Any investment institution that lagged behind by a few milliseconds might as well have been waving a sign saying "please front-run me."

HFT trading firms such as Getco, Knight Capital, Virtu and Citadel were the winners, and the losers were institutional investors that found it impossible to buy or sell shares at quoted prices. Many of them responded by moving their business off public exchanges and into dark pools where they were in theory less vulnerable to arbitrage.

Dark pools, sinister as they sound, were originally a sensible idea. Pools such as Liquidnet and PositAlert were created as venues in which an institution that wanted, for example, to sell 100,000 General Electric shares could find another that wanted to buy that amount. They could make the trade at the market price before being ambushed by algorithms.

"I don't think that many investors know what is going on inside the dark pools now," says Rhodri Preece, director of capital markets policy at the CFA Institute. "There is a lot of high-frequency trading and they are not being used for their original purpose." Suffice to say, the industry term for much of the trading that now takes place inside dark pools is "toxic liquidity".

The fact that many dark pools no longer offer to investors what they promised might be fine with the banks that operate them if they were making money. But high-frequency trading is far less profitable than it was, even for the leading firms. Tabb Group estimates its revenues in 2014 will be $1.2bn compared with the peak of $7.2bn in 2009.

We are witnessing, in other words, a classic Wall Street boom and bust cycle. Traders rush into a business that is profitable for those with an edge – in this case fast connections and clever algorithms – but others catch up and margins are eroded. After a while, it is hardly worth making a big investment for a diminishing return. Meanwhile, the risks are clear. The "flash crash" of 2010 was the first in a series of high-frequency pile-ups. Knight Capital lost $460m in 2012 from a software glitch and had to be taken over by Getco. Goldman itself lost $50m in August to a similar blunder.

"We have a messed-up market structure that created bad incentives and led to some bad behaviour," says one Wall Street executive. "Investor confidence is low enough as it is. If something really bad happened, the regulators would turn up with a draconian solution."

European supervisors are already attempting to correct some of the excesses allowed by Mifid with the Mifid II directive, which tightens the rules for dark pools. In the US, Eric Schneiderman, the New York State attorney-general, is calling for reform and Lewis's book will add to the pressure on the Securities and Exchange Commission.

It sounds like the time for an astute investment bank to switch sides, leap ahead of the backlash and the profit squeeze, drain its dark pool, reduce its exposure to NYSE trading and head for the moral high ground as fast as possible. What's that sound? Goldman calling.

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