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THE LAST WORD

High-frequency traders: heroes or hoodlums?

By Jonathan Davis

By using the emotive phrase “rigging the market” to describe the impact of high-frequency trading on stock markets, the author Michael Lewis has guaranteed himself both extensive publicity and enhanced sales for his book, *Flash Boys* .

In addition, by casting his story in Manichean terms as a tale of one heroic outsider taking on the evil big boys of Wall Street, he risks courting the accusation that he is special pleading for one vested interest rather than taking a principled stand against wrongdoing in the interests of a more general truth.

Yet on both counts it seems to me that he has had by far the better of the controversy that followed the publication of his latest offering. On Wednesday last week, by chance or otherwise, he found some powerful support for his arguments from a distinguished source, the Nobel Prize-winning economist Joseph Stiglitz.

In a speech at a gathering of the Atlanta Federal Reserve, Mr Stiglitz effectively skewered any hope of a defence of HFT on the grounds that it engendered greater market efficiency in the shape of enhanced liquidity and keener prices.

Calling on 30 years of research into the impact of innovation on financial markets, it was, he observed, far from clear that the arrival of HFT could claim to have generated positive social welfare. Yes, it may have reduced the speed of trading, and yes it may have increased trading volumes, but there is nothing in theory or logic to say that either consequence adds to the overall benefit of society. Indeed, the opposite may well be the case, both for the narrow community of professional investors and the wider community of participants in the real economy.

That seems a more than plausible conclusion, albeit one that has still to be formally tested, let alone proved beyond civil or criminal burdens of proof. The main point about HFT is that its development follows a familiar pattern: a potent combination of deregulation, technological advances and profit-seeking innovation by hard-nosed capitalists produces a game-changing new order of battle in an established area of market activity.

There will inevitably be winners and losers in any such struggle. In the case of HFT, the principal beneficiaries have been the high-frequency trading firms themselves. They have reaped consistent and reliable profits by taking risk to embrace and then exploit the opportunities created by the technology.

The secondary beneficiaries have been (a) the plethora of exchanges that have sprung into life since Regulation NMS in 2007 allowed competing exchanges to become profit-seeking entities and (b) the big broking firms that have been able to make money both by establishing their own “dark pools” and selling the execution of their customers’ order flows to third parties.

The argument Mr Lewis advances is that high-frequency traders have profited particularly from the ability to use the edge that their quicker access-to-order flow information gives them to “front run” the orders of other investors, something that in other guises has long been illegal. He highlights the fact that a number of high-frequency traders have had virtually no losing trading days for more than five years, a phenomenon that flies in the face of the common sense observation that trading is – or should be – a zero sum game.

Such a record implies, at best, that the high-speed traders are taking no risk, and at worst that they are exploiting an edge at other market participants’ expense – playing the markets, in the author’s telling phrase, the same way that card counters in a casino play blackjack. Meanwhile stock exchanges and broking firms, he alleges, have for some time effectively been complicit in this nefarious activity, often effectively at their clients’ expense.

If he is right, the argument that by reducing transaction costs and improving market liquidity HFT is working to the benefit of investors looks weak. Mr Stiglitz argues convincingly that the ability to

trade fractions of a millisecond faster than before is unlikely to be an advance that of itself has any real social value, net of the costs (in terms of heightened intraday volatility, loss of pricing transparency and other consequences) that come with it.

Most telling of all, I fear, is the fact that several of the participants in the HFT game have form. We might not have believed before, for example, that the big broking firms were capable of skimming profits from their own customers, but since the inquest into the global financial crisis we now know better. The Liborand forex scandals provide prima facie evidence that opportunities to rig a market in the world of finance, if offered, will be taken. Wall Street's moral compass, if not an out-and-out oxymoron, has patently gone awry in recent years.

In the interests of natural justice, the protagonists of HFT should clearly have a chance to defend themselves against the assorted crimes and misdemeanours of which they have been accused. Maybe they have been horribly traduced and we are all too stupid to understand what they do – in which case they have nothing to fear from a detailed forensic examination of their trading practices.