WHY TRANSPARENCY IS MORE IMPORTANT THAN FORCING 500 MS RESTING TIME ON ORDERS

A reflection on the MiFID II proposal and the effects on customer benefit

HFT (High Frequency Trading) has been a hot topic for quite some time. Some say it is good for the market and adds liquidity, others say it is bad and erodes the trust in the market. Regulators and politicians now feel the pressure to harness HFT, and the latest amendments to MiFID II with a proposal to require orders to rest for a minimum of 500 milliseconds at the exchange, is just one example. But the question is, what problem are they trying to solve and will the effect be the intended?

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DEFINING HFT

To discuss and understand the intention of MiFID II we first need to define high frequency trading. There is a common discrepancy in the definition which causes confusion.

A high frequency trader uses algorithms for decision making and order initiation with no human interaction. The orders are executed with high speed through low-latency connections to markets for order entry, and the message rates (orders, quotes or cancellations) are high.

If you fullfill these requirements, you are a high frequency trader, and you have an advantage in speed compared to others. Is that good or bad? Let's go through some "HFT strategies" and have a look.

Price arbitrage

Some securities are traded on multiple venues; the best price will therefore be found on one or several of these. In US there is a law to execute on NBBO (National Best Bid and Offer). In EU there is no law, but the best price is called EBBO (European Best Bid and Offer). The costly process of accessing all execution venues to have a true EBBO has resulted in some participants only accessing a subset of EBBO. This creates price discrepancies in the market and crossing prices that the fastest HFT firm can profit from. The solution is relative easy; get access to EBBO. In this aspect, HFT firms contribute to correcting price discrepancies while making a profit at the same time – HFT is basically facilitating a correct price mechanism.

Fishing

Fishing equals the process of using a small order to "ping" to see if there is a big order in the market, detect an interest and front run it. The process is the same whether fishing after an iceberg order or a dark pool order. The defense is easy, set a minimum accepted quantity and price limits on your order. Fishing has always been there and is not only related to HFT firms.

Modify reference price

Market orders are always risky, no matter if they are sent to the lit book or as a peg primary dark. If the lit book is thin - the cost of modifying the reference price is low. All orders should therefore have a price limit. Again, HFT adds nothing new to the issue.

Ticker tape trading / Event arbitrage / Statistical arbitrage

This is either fast detection of events in the market such as acting on news, or working with the fact that instruments are correlated and there could be errors in prices between them and acting fast on that. None of this is new to HFT, and none is bad for the market. Most are contributing to correct prices in the market and removing errors. In this area HFT firms are primarily competing with each other, and thus facilitating a correct price mechanism.

> The real problem, many argue, is trust in the market caused by the information gap that exists between market participants.

Front running

Front running is closely related to event arbitrage and means to detect a big interest in an instrument, act fast and buy before the general market does. Later when market catch up and price rises – you sell. This is allowed if you are an independent proprietary or HFT firm acting on public information – and illegal if acting on own customer flow or non-public information. This is not a new phenomenon and once again not only related to HFT. The only way to deal with this is to trade with as low market impact (avoiding creating patterns) as possible using appropriate venues and algorithms. And to make sure that the broker executing your orders has interests in line with yours and nothing else.

Quote stuffing

Quote stuffing means sending huge amount of orders to the market using the fact that you can deal with huge amount of order flow, but others cannot. Simplified, you "overload" other systems so that your real attentions are hidden and you can profit on information advantage. This is market abuse since you have no real attention to trade on the orders you send. It is the obligation of the exchanges to detect and remove such flow from the market. Dealing with this may include the exchanges limiting numbers of orders sent per second - or similar, possibly allowing a higher flow of orders if your executing rate is high.

> Post trade transparency is pre trade transparency for the next trade

EU REGULATIONS AND ITS POTENTIAL CONSEQUENCES

There are a number of upcoming EU regulations with the ambition to deal with the not yet defined HFT problem. Below we will go through some of the regulatory initiatives.

Removing rebates for passive flow

The objective with this initiative not very clear. The problem however, is that it will most likely remove the incentives to put passive volume up on display. This in turn will remove liquidity from the lit book - something that should not be in the interest of regulators. Moreover, it means putting a restriction on free competition between execution venues, which also makes little sense as one primary reason of the first version of MiFID was to create competition between execution venues.

500 millisecond minimum resting period

The suggestion to add a 500 millisecond minimum resting period on all orders adds risk to all trading and market making. If you place an order for 500ms you have no possibility to redraw the order and any event in the market can put you up for naked slaughter. Any other opportunities in the market during this time, and you have to let it be. **Contrary to its intentions, this will create new front running opportunities for HFT firms as it will give them a lot of time to figure out and act on an investors intentions to buy or sell a security. Moreover, it will remove liquidity from the lit book, since the risk of posting is high when you cannot redraw the order, and creates less trust in the market basic order matching functions since crossing orders do not execute (consolidated orderbook will show same bid and offer but nothing happens for at least 500ms, if crossing prices are on different venues).**

Continuous Quotes

Continuous Quotes is the obligation to always quote. If combined with the 500 milliseconds resting period, this means increased risk with smaller quotes and bigger spreads. This rule will most likely remove liquidity from the lit book, which is especially bad for market makers whose function is to bring liquidity to the market.

Order-to-trade ratios (OTRs) and other circuit breakers

The circuit breakers initiative is good as it may force exchanges to do their obligation to remove quote stuffing and set restrictions on unnatural movements preventing flash-crash scenarios in certain securities. This can actually make some good to the trust of the markets.

Consolidated tape

The idea of this initiative is to make the information regarding where all trades have been done, public. Since not everyone have this today, there is asymmetric information in the market. Professional customers that can afford BOAT can see dark and crossing network trades, others (usually retail customer) cannot. Not even all MTF trades are common information. **Consolidated tape means public post trade information to everyone. This is a very good initiative that would take us at least half way to total transparency. To receive the latter we would have to include public access to EBBO (the consolidated order book).**

SO WHAT'S THE REAL PROBLEM?

The real problem, many argue, is trust in the market caused by the information gap that exists between market participants. This is caused by the complicated price/rule structure of market data distribution. The customers deserves as a minimum execution at EBBO, but preferably also with a price improvement in addition to EBBO. The execution quality should be benchmarked and transparent. Customers need to be informed about what is going on in the *whole* market and how their orders perform in relation to the rest of the market. **Therefore there is a need of consolidated tape, or some similar solution that eases the burden of providing transparant data to all customers. Adverse information, even on market data, is almost as bad as trading on insider information. "Post trade transparency is pre trade transparency for the next trade" - Robert Barns, UBS MTF.**

We believe that if all this were to be considered and executed, we would move towards a truly transparent market with reestablished trust. With volumes declining globally, can we afford not to strive towards this?

SUMMARIZING AND CONCLUDING

Many argue that markets participants are contributing to the lack of trust in the market and feed HFT firms by not informing their customers about the market condition and not giving them access to EBBO. This needs to be taken seriously and can easily be taken care of by increasing focus on access to EBBO and consolidated tapes.

As for the exchanges, it should be a top priority to review their strategies and add long lasting market trust as a goal. Implementing efficient circuit breakers and setting market to order ratios that look the same regardless of execution venues should be their foucs, even now, before MiFID II.

If EU regulators should do anything at all, it is first of all to deal with the complexity of market data distribution. There is hardly no scale in market data distribution today. Exchanges should get their per-user-fee, of course, but they should not force everyone to pay huge yearly fees for becoming vendors at the same time. A vendor must be able to use its scale to provide data for many users, and for its customer's customers. So called "uncontrolled feeds" must be possible to provide with legal arrangement and trust, and with follow-ups in place to make sure the exchange gets its money. Alternatively the per-user-fee should simply be removed as the exchanges have no marginal cost for when a vendor adds an extra customer.

We believe that if all this were to be considered and executed, we would move towards a truly transparent market, with reestablished trust. With volumes declining globally, can we afford not to strive towards this? ■

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