

Clinton's Flash-Boy Penalties Outstrip the Eurocrats in Brussels

Hillary Clinton's plan to rein in high-frequency trading goes farther than even the politicians in Brussels dared to go.

The Democratic front-runner's proposal to charge a fee for canceled transactions would target computerized trading firms that repeatedly submit and then retract their stock orders. European Union politicians considered such a move in their overhaul of market regulations after the financial crisis, but stepped back from the brink.

Repeatedly placing and retracting orders is a mainstay of market makers -- the trading firms that post orders to buy and sell stocks and continually adjust them. Advocates say those those bids and offers are the lifeblood of modern financial markets, while critics claim the orders can be canceled so fast and so often that they provide an illusion of liquidity and could cause market instability.

"If you're an electronic market maker, then you have to have the right to be able to reprice your merchandise, the same way that anyone selling anything has the right to change prices," said Steve Grob, global director of group strategy at Fidessa Group Plc. "These types of proposals point to the politicizing of regulations, which isn't really a good thing for markets or investors."

European officials pushed^[1] for mandatory higher fees on placing orders that are subsequently canceled, but^[2] national governments disagreed.

"The European Parliament was in favor of achieving a high degree of harmonization in order to avoid regulatory arbitrage," Markus Ferber, the German lawmaker who led the assembly's negotiating team on the bill, said on Thursday. EU countries "argued that they needed more flexibility in order to make the system work for different venues with different characteristics," he said.

For every 27 orders placed on U.S. stock exchanges, about one is filled, according to data from the U.S. Securities and Exchange Commission. In other words, approximately 96 percent of all orders sent to U.S. equity markets are canceled.

‘Flash Boys’

HFT concerns went mainstream after Michael Lewis, author of the book “Flash Boys,” described the business on the U.S. news program “60 Minutes.” In his book, Lewis accused the firms of rigging markets by front-running the trades of other investors.

“In popular opinion, HFT is bad,” Albert Menkveld, a professor at VU University Amsterdam who studies high-frequency trading. “The feeling is, how can that be good? If they’re making money it’s coming out of my pocket. The HFTs have had trouble communicating the liquidity provision aspect of what they do.”

Rather than require fees for canceled trades, EU regulators went forward with a measure that requires HFTs to continue trading even when volatility jumps. The rules try to make market making more stable in part through a written agreement with the trading venue, in which the two sides agree on the trading firm’s obligations as well as incentives such as rebates.

Combining those rules with a penalty for canceled trades wouldn’t have been compatible.

Market Maker

France and Italy have financial transaction taxes that provide an exemption for market makers. Italy’s exchange, meanwhile, went a step further and implemented a plan that penalized higher order-to-trade ratios. Attempts by 11 EU countries to agree on a financial-transactions tax are progressing slowly.

A review^[3] commissioned by the U.K.’s Foresight Project wrote that even some HFTs and stock exchanges were in favor of such schemes, as they could be “disciplining devices to prevent sloppily written computer code from generating pointless order entries and revisions and using excessive bandwidth.” Overall, however, the study suggested that the policy damaged liquidity somewhat in Italy.

“Without anybody putting quotes in, there’s not even the possibility of trades,” Menkveld said. “With FTT, you throw away the good and the bad. One should be more concerned about behaviors rather than a particular group.”

1. <http://www.europarl.europa.eu/sides/getDoc.do?type=COMPARL&reference=PE-485.882&format=PDF&language=EN&secondRef=01>
2. <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0065>
3. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/289046/12-1077-eia18-order-to-trade-ratios-impact-italian-stock-market.pdf

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