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# Katsuyama On Difference Between “Predatory HFT” vs. “Market Makers”

by [Mark Melin](#)

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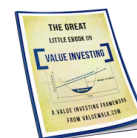
**As study says speed increases cost, question is how do you differentiate between real liquidity and HFT bandits?**



[Faster trading](#) does not lead to investors obtaining the best price for stocks, according to a study by European academics who considered the NASDAQ OMX Group, Inc. ([NASDAQ:NDAQ](#)) trading venue.

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## Study notes increase in cost with faster trading

The study, led by University of Amsterdam's Albert Menkveld and reported in Bloomberg, noted that when NASDAQ OMX Group, Inc. ([NASDAQ:NDAQ](#)) upped the speed in markets in Copenhagen, Helsinki and Stockholm in 2010, it ignited a heightened pressure on market maker profits, which actually widened the cost to investors.

## Katsuyama differentiating between market makers and HFT bandits

The study uncovered a little discussed yet critical issue in high frequency trading (HFT) – differentiating between the market maker and the directional high frequency trader. Market makers have always been essential to market structure, providing two sided liquidity and profiting off the spread between the cost to buy and the lower price to sell a stock or commodity. High frequency trading, on the other hand, had traditionally viewed by some as a predatory practice. Yet official regulatory distinction between the two efforts has yet to materialize.

“There is definitely a race between electronic market makers and more aggressive HFT strategies that look to exploit structural inefficiencies in the market,” said Brad Katsuyama, CEO of IEX, a trading venue profiled in the book *Flash Boys* by Michael Lewis. “The market maker wants the quote to stay stable and earn the spread, while the predatory

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strategy wants the price to change to create inefficiencies. The problem is... Everyone purports to be a market maker.”

## **Katsuyama: HFT strategies are really a wolf in sheep’s clothing**

In this quote Katsuyama hit on a key point of differentiation. Everyone wants the market maker designation when in reality many HFT strategies are really a wolf in sheep’s clothing. Separating the trouble makers from the good kids on the playground is a task that cuts right into the heart of the HFT contagion.

In the University of Amsterdam study, the researchers noted that when exchanges got faster, simply moving from a reaction time of 250 microseconds to 2,500 microseconds, it encouraged speculative “bandits,” the report noted.

“We care less about what any firm says and more about what they do,” said Katsuyama, noting that by design they eliminate certain structural inefficiencies on our market by slowing down trading. “The precision of adding a 350 microsecond buffer is not an accident. A few independent high-speed trading firms are connected and consistently behaving as market makers on our platform, while dozens of other high speed firms won’t connect. That seems to be a pretty good indicator of who the real market makers are.”

In discussing specific issues to be addressed, Katsuyama was signaling a move past argument to action. As he termed it “we’re getting to specificity and precision instead of rhetoric, generalities and murky middles.” Katsuyama said the real issue is “where do we go from here to move the industry forward?”

## **Tabb notes regulatory action at FINRA, SEC on HFT**

Evidence exists on both sides of the speed debate, as academic reports have cited high frequency trading as reducing trading costs. As previously reported in ValueWalk, Larry Tabb, founder and CEO of Tabb Group, a market research firm, has previously noted that lowered trading costs in the stock market may not be a universal positive, as it does not provide incentive for a “sticky market.”

One answer to tackle the HFT problem is to increase transparency and

awareness of HFT trading activities. In new Tabb Group commentary from NY-based research analyst Valerie Bogard, “*Transparency Is Trending in the Capital Markets*,” she says that regulatory agencies not only are requiring greater reporting from industry participants, they also are doing a better job leveraging the information they have and making it more accessible to outside parties.

Last week marked the first week that alternative trading platforms such as dark pools were required to report trading volume to equity regulator FINRA, with the reports due yesterday. Tabb Group has published dark pool trading statistics but the numbers are voluntarily reported by the dark pool participants.

Tabb also noted with interest the SEC’s new market structure website that provides significant visualization tools to monitor high frequency trading. The web site has been receiving significant relative traffic, with nearly 75,000 page views. The response to the site has been remarkably positive. “That may not seem extraordinarily high compared to sites like Facebook or BuzzFeed, but considering this is a regulatory agency website that details the volumes of odd lots rather than the 50 best pictures of cats, it’s pretty impressive – and it shows that there is real appetite for this data, from both the market and the general public,” Tabb humorously noted in a statement.

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Wait: is Katsuyama saying that the difference between a "predatory HFT" and a "market maker" is whether or not they trade at IEX? That's more than a little self-serving, isn't it? Maybe that trading entity doesn't trade the products that IEX specializes in or operates a strategy that is otherwise not conducive to the IEX market structure. Then again, it could be that IEX has a market share somewhere around one-half of one percent (0.005) and it is therefore not worth the time and effort to connect and trade there.

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