

Commentary: Do High-Frequency Traders Add Value to the Market?

By Stephen J Nelson; The Nelson Law Firm, LLC

Originally Published in *Traders Magazine* on December 15, 2009

<http://www.tradersmagazine.com/news/high-frequency-traders-liquidity-104785-1.html>

Heinrich Schliemann earned a place in the history books by discovering the ancient City of Troy in 1869. But before making this contribution to our cultural heritage, Schliemann was a trader.

Literally washed up on the shores of the Netherland as an impoverished teenager, Schliemann ultimately found employment with B. H. Schöder, an import/export firm. As it happens, Schliemann had an amazing ability to learn languages, and was ultimately fluent in 13 languages. Schöder's clients usually could not speak the language of ship captains. So, Schliemann's job was to serve as a translator for clients purchasing goods from ships that docked in Amsterdam.

Schliemann quickly realized an important fact of life that remains true to this day. Translators, no matter how amazing their linguistic skills, receive a pittance for their work. Successful traders, by comparison, can make millions. So Schliemann pretended to translate the offers of ship captains, while actually purchasing the goods for Schöder's principal account and then immediately reselling them for a profit to unwitting clients. Schliemann applied this technique with sufficient skill to avoid detection, making him a great success at Schöder and personally very wealthy.

Of course, Schliemann was perpetrating a fraud on his clients. They were not hiring him to front run their purchases, but to act as a translator.

But, there is also a larger point. Schliemann wasn't adding any value to the transaction, other than serving as a translator of foreign languages. The free market's judgment was that he should receive a pittance for his work, like other translators, rather than a great fortune as a trader. Schliemann's profits were derived by skimming an advantage that rightfully belonged to his clients.

Institutional investors are in constant fear of being skimmed, which has spawned a growth industry in trading products designed to outwit the skimmers. Before things got so automated, institutional sales-traders would cater to these fears by offering to find the "natural" other side. The theory was that if, for example, T. Rowe Price were to sell directly to Fidelity, they would receive a better price, all other things being equal, than if the sale were made to Merrill Lynch, a market maker.

Naturally, a trading firm that could boast clients like T. Rowe Price and Fidelity could make this claim more credibly than a smaller firm that lacked such relationships.

Since the advent of Regulation NMS, dark pools have been all the rage. Pools that only have as members other big institutional investors are exclusive clubs where there can be more assurance that another big institution is taking the other side, rather than a modern-day Heinrich Schliemann.

The problem with this strategy is that institutions, not unlike lemmings, tend to move in the same direction. The reason for this is that securities analysts for institutional investors like to share notes, if not with each other directly, than indirectly through conversations with securities analysts at investment banks. Humans are social creatures, which means that we like to confirm our ideas with other like-minded people. The result is that everyone tends to be a buyer, or a seller, at the same time. The Europeans call this type of investment behavior “herding.”

The consequence of herding is that when an institution seeks the “other side,” it is more likely than not that a dark pool made up exclusively of other institutional investors will not produce one. It is at that point that a human trader earns his or her keep. A human will start calling institutions that have been interested in a security in the past to find someone who is interested. Institutions that have been generous with their commissions in the past are likely to get the first call. This gives them the opportunity to “price the merchandise.”

An institution could, of course, make its own calls to find the natural other side. But, that might give away a secret investment strategy to a competitor. A trader from a brokerage firm that works with lots of institutions is anonymous.

Sadly, humans are much more expensive to operate than computers. As a result, institutional sales-traders are an endangered species, and institutions nowadays seek to communicate their trading interest with other institutions through anonymous machines.

So where do high frequency traders fit in?

The usual claim is that high frequency traders provide liquidity to the markets. And, under certain circumstances, it might be true.

A trader provides liquidity to the markets by taking a position. This might happen where an institution wants to sell, but there are no buyers. A trader might believe the lack of buyers is temporary and take a position to accommodate a client. The now defunct New York Stock Exchange specialist was supposed to fill this role.

Modern equity markets have all but driven position traders into extinction. The reason for this is that the institutions wishing to sell have a lot more information about the position than the position trader. So, the trader runs the risk that the value of the position will decline immediately after its purchase. When spreads were larger, the position trader was in a position to take on more of this risk. Narrow spreads removed any possibility of profits from position trading.

It seems to me that high frequency traders are not akin to position traders. Instead, their goal is to get between natural investors by reacting to bids and offers faster than they can. This is essentially the role played by Schliemann, dressed up in high tech garb.

We have heard the liquidity argument before. The SOES bandits, and later, the day traders, all claimed to provide liquidity to the markets. Liquidity, like patriotism, is in many ways the last refuge of a scoundrel.

That said, it's not clear to me what can be done about it. Unlike Schliemann, high frequency traders aren't defrauding anyone. They aren't claiming to be anything more than they are.

Some have suggested doing away with the sponsored access to markets that high frequency traders use to avoid taking on the burdens and costs of broker-dealer registration. The theory behind this argument is that more supervision is required of high frequency trading activity. But, no one has identified any rules that are being broken. So, doing away with sponsored access would raise the costs of high frequency trading without any corresponding regulatory purpose. The result would be less competition, the side effect of any regulation, without any articulated benefit to the investing public. Less competition is not a valid regulatory goal.

Even if we think there ought to be a law, I can't envisage the market structure "improvement" that would not amount to throwing the baby out with the bath. For example, I have heard a lot of talk recently about "slowing the markets down." But, we live in a world of high-speed communications, as well as high frequency trading. If we slow markets down, legitimate investors that are not high frequency traders will be deprived of an opportunity to react quickly to fast-breaking events.

So, what can be done?

I think the answer is that high frequency traders should provide information about their activities to the SEC. At a minimum, we want our regulators to be well-informed. If we have learned nothing else from the great market crisis, we should be able to agree that while the government that governs least may govern best, the market regulator that knows the least, regulates worst.

In the meantime, we await the next great contribution to our culture by a trader.