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HFT Demise as the Precursor to Changes in the Markets Landscape

February 26, 2013

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As new marketplaces and business models emerge, the industry should be prepared for an entirely new wave of custom IT systems and applications

The recent spate of media articles surrounding declining profits for specialist firms within the High Frequency Trading (HFT) space have pointed to some of the less visible undercurrents in the global process of capital markets restructuring. The ebb and flow of the financial markets turmoil that has been evident since 2008 naturally serves as a renovating force, disrupting long-established and entrenched businesses and institutions and giving rise to new habits and new players. As with every crisis in history, at the highest level, the plot consists of two components: incumbents' attempts to preserve status quo, and the arrival of eager newcomers seeking to exploit opportunities left in the crisis' wake.

The existing players exhibit two broad kinds of behavior. Regulators and critical institutions are striving to retain their tight control over the markets, while at the same time continuing their usual policies of increasing the system robustness, mainly by curbing leverage (which may be a good thing) and containing volatility (which is probably misguided). Large-scale independent players, from global banking conglomerates to leading asset managers, are naturally inclined to avoid costly and excessive regulations that depress their profit margins and restrict their business creativity.

Once the first acute stage of the crisis was over, multiple start-up companies began to appear. With the incumbents somewhat weakened and the entry barriers lower than before, these companies experimented with innovative and sometimes very unorthodox business models. Some of the most interesting of these operate in the area of "private" or "alternative" marketplaces, where new intermediaries are devising new ways to match buyers and sellers and attract they types of capital users or investors that have not been significantly involved in the markets before.

In addition to these general market trends, several sub-trends are now poised to significantly impact the capital markets. One such trend is the increasing movement of institutional and sell-side proprietary players' trading activities out of established exchanges. This ecosystem is very much in flux, as they need to confidentially operate in more specialized and restricted marketplaces, and optimize their execution costs.

Another clear trend concerns exchanges. The old argument in favor of a few centralized exchanges, namely that they increase the available liquidity, is no longer strong enough. It is now clear that the overall amount of liquidity in the system is so immense that for certain asset classes (such as cash equities) decentralization and specialization would certainly not create notable systemic inefficiencies. In fact, these are areas where smaller trading platform providers can thrive.

[Stephen Colbert Takes on HFT]

As for the stock market, the disintermediation trend is the most visible. The last decade has seen a revival and rapid expansion of the "dark pool" model that allowed large investors to trade sizeable blocks of shares without adverse price movements they would suffer in a public exchange. According to TABB Group research, the volume of shares traded via dark pools increased from 1% to 12% between 2005 and 2010. In recent years medium-size asset managers have started to turn to off-exchange platforms as well. At the other extreme of the

market, the “social trading” phenomenon enables direct and efficient transactions between small-scale players. Some firms are now going beyond that and trying to compete with exchanges directly. Credit Suisse is currently in talks with US regulators, aiming to turn one of its trading platforms – aptly named “Light Pool” – into a full-blown stock exchange. The new trading venue will pose a difficult problem for SEC commissioners; a bank-owned exchange would be unprecedented both from an operational and regulatory standpoint. It will also be a direct rival to existing stock exchanges, eating into the revenues they earn from trading fees.

As we’ve previously highlighted, another poignant trend can be seen in the evolution of marketplaces for alternative assets such as diverse credit instruments. New intermediaries are appearing in the area of trade and export financing that do not provide liquidity themselves (like traditional banks would do to their corporate clients), but instead match credit-constrained liquidity users with sophisticated investors eager to buy new high-yield credit products. Such a marketplace typically operates as an auction platform, giving the sellers attractive terms and thus increasing the overall supply of investable debt instruments to potential investors. These “non-bank capital” marketplaces are emerging to serve the sellers both globally and within specific geographies and sectors.

With all these events, the incumbent exchanges are beginning to lose relevance. While their role remains pivotal in asset classes like commodities and exchange-traded derivatives, it is yet to be seen whether they will retain their position in the stock market. These exchanges have secured a great deal of clout over the past decade – but have been subject to little regulatory scrutiny. The botched Facebook IPO was probably the straw that broke that particular camel's back. In addition to numerous lawsuits, key players on both the sell and buy-side are now beginning to lobby against the "abuse of power" on the part of the exchanges. As several big boys' move to alternative marketplaces, any changes in the regulatory landscape are likely to pose new threats to the incumbent exchanges' business.

When it comes to HFT, the continued media coverage has essentially demonstrated that, contrary to popular stereotypes, HFT firms were not so much exploiting ultra-short-term information inefficiencies (with all the usual heavy duty engineering romantics of "trading at the speed of light"), as they were piggybacking on the deficiencies of an outdated environment (i.e. the fully automatic order crossing exchange that is now so familiar). Interestingly, HFT firms have increasingly begun to trade in the dark pools, adapting their strategies to this different landscape. They are actually being welcomed by dark pool operators for adding liquidity to their venues. It has been estimated that only 5-10% of typical dark pool trading volume occurs between institutional players. On one hand, HFT firms just follow the trade flow they used to profit from. On the other hand, they too feel the pressure from regulators and are seeking alternative trading venues just like their institutional brethren.

Undeniably, the rise of a new generation of marketplaces creates a myriad of opportunities for multiple industry players – but these opportunities will also come with their own technology challenges. As new marketplaces and business models emerge, the industry should be prepared for an entirely new wave of custom IT systems and applications -- few of which could possibly be serviced today using existing commercial products.