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Wall Street's no-longer-so-secret society: High speed trading gets scrutiny, rivals

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Chris Graythen, AP

An arms race has begun in the secretive world of high frequency trading, the practice of making a high number of trades netting small gains that can add up to big profits at the end of the day. Fueling the competition is the entry of more players into the field as well as technological advances that continue to enhance the speed and quality of trades. A sense of urgency comes from the fact that the industry is bracing for new regulation.

Becoming increasingly popular in the last couple of years, high frequency trading uses technology and computer algorithms to take advantage of sub-millisecond arbitrage -- or essentially the spread between the buy and the sell price of a stock or commodity that can appear in fractions of a second. But the trading technique has come under scrutiny for several reasons. Some fear that stocks could be manipulated by the practice. There's also the concern that high speed trading gives an unfair advantage to high-rollers and major institutional clients who can afford the expensive, high-tech setups needed to participate.

Now as the industry grows, players are battling each other over market share and butting heads with critics over how the industry should be regulated. At a New York conference on the future of high frequency trading sponsored by the Mankoff Company last Thursday, traders lamented that the good times may be over.

Forced to Adapt

At the conference, experts said they were concerned regulators could adopt a heavy-handed approach to regulating high frequency trading as part of reforms to the financial system. Traders are uncertain about what type of new regulations may come from the U.S. Securities Exchange Commission or Congress. The biggest fear is that regulators could potentially move to ban high frequency trading altogether. Less dramatic, there could be restrictions on trading volumes or new taxes being levied on the industry to rein in profits.

"You could be put out of business overnight by one regulation," said Michael Graves, principal at hedge fund manager Tesseract Capital, who raised the possibility of a highly short-term capital gains tax, or a transaction tax being enacted, which would negatively affect overall profits.

Faced with new regulations, Gray Long, chief information officer for Trading Cross Connects, said that technology and innovation would immediately be implemented to find "work-arounds." He suggested that as soon as any new regulation is enacted, new algorithms could be created to adapt and find trading strategies that would be able to help firms profit in the new environment.

Strategy Over Speed

New regulations and closer scrutiny of the field may end up separating the wheat from the chaff. Which companies will survive? Experts at the conference said that having a long-term strategy will ultimately be more important than the speed of a trader's system.

Many companies that want to enter the high frequency niche may emphasize the speed of their systems and may not understand everything that is necessary to be successful in the current environment, Allen Zaydlin, CEO of electronic trading software firm InfoReach, said. The speed of decision-making, of accessing updated market data and of the networks and equipment traders use all play a role in an organization's success.

But in most cases, a long-term business strategy will win the day, he said, because no matter how many thousands you spend creating the infrastructure needed to compete with speed, ultimately, "somebody comes with newer, more modern and optimized equipment, and you have to rethink your strategy."

Emmanuel Doe, a global business manager for Thomson Reuters (**TRIN**), also pointed out that rather than focus on speed, understanding which markets to trade in and when to make trades could be a very profitable approach. A short series of well-executed trades could reap benefits similar to the high volume, ultra-fast trade model.

"Depending on your strategy, there is still money being made from high frequency trading, but not from super microsecond arbitrage." Quant traders, for example, use the same technology as high frequency traders, but hold their trades for several days.

New Markets Beckon

Going forward, traders who want to thrive in high frequency trading must find ways of expanding the number of markets they actually trade in, experts said. High frequency trading in equities is becoming more difficult because the space is becoming crowded with new players. In particular, the U.S. equities market is "exhibiting bubble-like qualities, Graves warned.

"High frequency is most likely not the best investment in the U.S., specifically in equities," he emphasized. "There are much better opportunities taking [your trading] expertise, the infrastructure and all that technology and applying it in other areas and to other asset classes."

Companies with expertise in equities trading may look to diversify by trying high frequency trading in bonds or other asset classes to broaden financial opportunities, experts said. Some suggested international equities markets, where high frequency trading may not be used as much, as a place to gain a foothold in the field.

While diversifying into different markets is essential to long-term survival, Long said, doing so will carry a significant cost. The bigger challenge? Firms will have to adjust their cost structure to pay for the millions of dollars worth of technological upgrades and maintenance needed to remain competitive. "The drag on company performance is enormous," he said.

Even with the potential costs, Emmanuel predicted more institutions may bring trading operations in house to increase the quality of the execution of their trades. Some trading firms have spread themselves thin, and with competition and scrutiny increasing, problems with a lack of transparency and accountability at trading firms holds potentially more dire consequences.