

## High Frequency Trading

Some call it low latency trading. Others call it high frequency trading. Some say it adds liquidity to the markets. Others say it exacerbates volatility and disadvantages the long only investment manager. Whatever you call high frequency trading (HFT), it is hard to ignore the attention it has received lately. From talk of regulations to "should I participate?", HFT is a hot topic.

What exactly is high frequency trading? While there is no standard definition, it is generally believed that high frequency trading is the rapid and automated placement of orders, many of which are immediately updated or canceled, as firms hunt for temporary inefficiencies in the market where they can take advantage of unique market situations.

With high frequency trading, it is all about speed. Powerful computers that are co-located near exchanges provide millisecond trading and exchange of information. This speed is what provides trading advantages to HFT firms.

Many industry participants are concerned about how high frequency trading affects the marketplace. To address these concerns, several industry and regulatory initiatives are being implemented and/or proposed which could have an effect on high frequency trading.

- **Restricting Access** - Many algorithm providers and ATS providers are restricting high frequency traders from interacting with their trading offerings. They feel that high frequency traders are picking off their institutional order flow, disadvantaging their traditional client.
- **Reviewing HFT Code Secrets** - In a recent, unprecedented move, regulators are pressuring high frequency trading firms to hand over their secret trading codes. Regulators are trying to figure out whether high frequency actually provides liquidity to the marketplace or just harms it.
- **Large Trader Reporting Rule** - Through the large trader reporting requirements, regulators will have a valuable

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source of useful data to support its investigative and enforcement activities, as well as facilitate the SEC's ability to assess the impact of large trader activity on the securities markets for regulatory purposes.

- **Consolidated Audit Trail** - This proposed system would help regulators keep pace with new trading technology and trading patterns in the market. It would allow the SEC to rapidly reconstruct trading activity and quickly analyze both suspicious trading behavior and unusual market events.
- **Trade-at Rule** - The SEC's proposed trade-at rule could negatively affect a high frequency trader's strategy as increased latency could come into play if orders need to be routed to other execution venues due to the Rule's requirements.

According to the Tabb Group, it is estimated that high frequency trading accounted for about 65% of the overall US trading volume in August, which was a particularly volatile month. However they state that high frequency trading provided 53% of trading volume so far this year versus 61% two years ago. Other statistics show that high frequency trading accounts for as much as 75% of overall trading volume. The discrepancy could be due to the way trades are classified - high frequency versus low latency. In any event, it is evident that high frequency trading accounts for a large portion of equity trading volume.

Liquidnet conducted a survey finding that approximately two-thirds of institutional investors are concerned about the consequences of high frequency trading on the stock market. It also found that institutional investors are vastly opposed to high frequency trading as they believe it disadvantages traditional institutional investors and increases the cost of trading. Many believe that high frequency trading should be a high priority market structure issue.

There is no doubt that computerized trading has changed equity markets. As regulators work through the high frequency trading debate, they must thoroughly understand how human traders and electronic trading systems interact as any regulatory changes that take place could have a profound impact on the market.



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Capital Institutional Services, Inc. | 1601 Elm Street | Suite 3900 | Dallas | TX | 75201