CAPIS CONNECT

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High Frequency Trading

Mention the term "high frequency trading" (HFT), and you are sure to get opinions from both ends of the spectrum and everywhere in between. While this trading practice has been a topic of discussion for several years, it has recently become a more heated issue since *60 Minutes* aired a segment discussing the new book, "Flash Boys".

In the wake of the renewed publicity of HFT, we, at CAPIS, wanted to share our views on this trading practice, our practices as a firm, and our thoughts on this topic as it relates to regulation.

What is High Frequency Trading?

High frequency trading is a type of algorithmic trading that utilizes sophisticated technology and computer algorithms to trade securities at higher speeds than other brokers. The speed for which these proprietary strategies allow, creates the ability to move in and out of positions in fractions of a second in search of temporary inefficiencies in the market. This provides an opportunity to capitalize on unique market situations to which those not using HFT, have no access.

With high frequency trading, speed provides the advantage. High frequency trading shops use powerful computers that are co-located near exchange servers. These computers provide millisecond trading and an exchange of information at a speed that helps the HFT shops' orders go to the front of the queue.

For many years, HFT firms operated quietly in the background. Yet, they quickly grew to approximately 60% of shares traded in the U.S. markets, while generating an estimated $5.0 billion in profits at their peak, in 2009. Today, these same firms account for less than 40% of shares executed and are on pace to generate $1.2 billion in profits this year; down 75% from 2009. Lighter volumes and less volatility have contributed to the downturn in HFT activity.

Although high frequency trading is inclusive of all electronic order flow, not all HFT is created equal. High frequency firms use their capital to fill orders at, or better, than the NBBO; facilitating millions of executions each day for investors. Problems arise when privately-owned HFT firms, trading primarily for their own account, utilize speed and technology to gather information, allowing them to react to and anticipate order flow, to gain an advantage over traditional investors.

How did High Frequency Trading Start?

High frequency trading is a result of the "electronification" of trading. Regulation NMS, market fragmentation, and loopholes facilitated the proliferation of HFTs in filling the role of market makers when they were forced to exit a business that was no longer profitable under the new rules. HFTs are the new age specialists, replacing the traditional human floor-broker with cornputers.

How is the Industry Dealing with HFT?

In recent years, individual investors, banks, brokers and even HFT firms have adapted to high frequency traders. Some have built smarter algorithms in an attempt to outsmart HFT algorithms, while others have tried to restrict, or turn off, execution destinations that allow HFT flow into their liquidity pools. Many have also spent tens of millions of dollars trying to keep up with the ever increasing speeds of HFTs, just to find out something faster was already in the making.

IEX, a new alternative trading system, believes the answer to HFT, is to actually slow down the speed of systems delivering orders to execution venues, and to restrict the reaction time allowed to respond to market orders, in an attempt to level the playing field for investors. Only time will tell if their theory is successful.

CAPIS and High Frequency Traders

CAPIS does not own, invest in, or operate an HFT. While every order has the potential to trade with a high frequency firm, due to the interconnectivity of the market and the current market structure, we do not actively seek to participate with these firms.

As an agency broker, our only goal is to provide best execution on every client order. CAPIS only works with a select group of execution partners who are continually monitored for execution quality. Our traders use the latest in trading technology to facilitate trading decisions and to actively work orders to circumvent high frequency traders. By using aggressive limits, sourcing multiple pools of liquidity, and utilizing multiple algorithms simultaneously, our traders limit the potential of exposing orders to high frequency shops. Technology, coupled with our active, hands-on approach to execution, results in better performance and specialized customer service, placing CAPIS one step ahead of the competition.

The experience of our trading staff sets CAPIS apart from our competitors. Our traders have an in-depth understanding of the market and its participants, knowledge that has been honed for years. CAPIS' traders average more than 15 years in the industry and have experienced all of the changes in market structure over the past several years.

Using CAPIS for your trading needs means: CAPIS' selective criteria for execution partners, our team of highly seasoned traders, and our utilization of the latest trading technology to help you avoid high frequency trading firms.

CAPIS' Thoughts on HFT

We believe the industry is in need of a thorough market structure cleansing; though not a complete reform. Regulators need to collect data and vet out every scenario to formulate a system that is fair and equitable for all market participants. Any new regulation needs to address more than just the speed at which orders, and cancel/replaces, can be sent to an execution destination. Speed is not the only issue. Today's complex market structure consists of multiple exchanges, numerous dark pools, a variety of matching engines, maker-taker fee structures, technology inequalities, priority access and regulatory loopholes, that all lead to a break down in true price discovery and market stability.

The primary focus of any new regulation should be to simplify the current structure, minimize the advantages of HFTs, re-establish true price discovery, and regain investor confidence. What the industry does not need is quick, knee-jerk reactions to a media frenzy created by self-serving individuals with a product to sell. To protect against the ill effects of HFT market activity, the most diligent thing investors can do at this time, is continue to monitor their executions from brokers and venues and conduct due diligence meetings with brokers to discuss how they protect each order against predatory players to ensure best execution. Additionally, all market participants should engage in conversations and weigh in on the topic; making your opinions and concerns known to the regulators.

Conclusion

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.

While electronic trading has lowered trading costs and tightened spreads to the benefit of investors, it has also made it more difficult for HFT shops to win at their own game; taking advantage of price discrepancies and wider spreads.

CAPIS
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