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April 16, 2015

Comment to SEC Proposed Rule: Exemption for Certain Exchange Members

The floor of the New York Stock Exchange is largely a prop for CNBC. Instead of buy and sell orders being filled on the floor, trading occurs electronically, miles away at a data center in Mahwah, New Jersey.[1] Electronic trading has brought lightning fast speed to the execution of orders. Among the market participants- the mutual funds, big banks, proprietary trading desks, brokers, and hedge funds- there is a new class of trader, the high frequency trader (HFT). The Security and Exchange Commission's (SEC) Regulation National Market System (Regulation NMS) was designed to promote competition and price improvement but has since been blamed for overly fragmenting the market and giving rise to high frequency trading. There are currently eleven stock exchanges and forty-five dark pools, totaling fifty-six trading venues, which is a number that is hard to regulate and monitor.[2] Recent negative publicity surrounding high frequency trading, specifically Michael Lewis' book *Flash Boys* that claims the markets are "rigged," caught the SEC off guard.[3] The negative attention put high frequency trading in the crosshairs of SEC Commission Chairwoman Mary Jo White, who has vowed to reign in high frequency trading in order to "promote market stability and fairness."[4] This proposed rule by the SEC is trying to reign in something the SEC clearly

[1] Rich Miller, *NYSE's Data Fortress Powering the Financial Cloud,* DATA CENTER KNOWLEDGE (June 30, 2011) (available at http://www.datacenterknowledge.com/archives/2011/06/30/nyses-data-fortress-powering-the-financial-cloud/).
[2] Michael Lewis, *Flash Boys,* p. 20 (2014).
[3] Mary Jo White, *Testimony on "Oversight of the SEC's Agenda, Operations and FY 2015 Budget Request" Before the Committee on Financial Services U.S. House of Representatives*, 113th Cong. (April 29, 2014) (statement of Mary Jo White, SEC Chair, proclaiming "the markets are not rigged.")
[4] Mary Jo White, *Testimony on "Enhancing Our Equity Market Structure" presented at Sandler O'Neill & Partners, L.P. Global Exchange and brokerage Conference*, New York, NY (June 5, 2014).

does not understand. With this rule, the SEC wants HFTs to be under the oversight of FINRA- but to what end? It does not appear that FINRA has any more insight into what is happening at HFT firms than the SEC. This rule will merely cost HFT and proprietary trading desks millions of dollars in fees annually with no benefit to the investing public at large. In fact, the rule may harm the investing community be hindering the benefits of high frequency trading. Ultimately, the rule will line the coffers of FINRA with HFT money.

Harmful Costs

As previously stated, this proposed rule will have significant costs to high frequency trading firms and other proprietary trading desks of major financial institutions. The average cost to the firms to comply with the new regulation seems to be somewhat correctly outlined in the proposed rule, which amount the SEC estimates will cost each firm $3.25 million to implement, and then $2.7 million on an annual basis. However, such costs do not include the cost to FINRA and the SEC to store, analyze and interpret the data. Nearly 70% of all daily trading volume is attributed to high frequency trading.[5] High frequency traders also submit and rapidly cancel over 90% of their orders.[6] This will be quite a lot of data for FINRA to collect and analyze, no doubt at great expense to the organization. The cost to FINRA and the SEC of understanding and analyzing this data will ultimately be spread across the industry, resulting in fees for every market participant to increase.

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[5] United States Congress, Senate, Senateommittee of Banking, Housing and Urban Affairs, *Computerized Tradin: What should the Rule of the Road Be?* (September 20, 2012).

[6] Security and Exchange Commission, *Concept Release on Equity Market Structure,* Concept Release, p. 6, January 14, 2010 (available at http://www.sec.gov/rules/concept/2010/34-61358.pdf).

Potential Harm to Investors

The SEC has also not considered how the proposed regulation may effect or increase costs to the individual investor and the investment community at large. The SEC should consider how this regulation might impact market liquidity and overall trading costs, because it would seem that the regulation would decrease market liquidity and increase overall trading costs. On December 1, 2014, SEC economist Austin Gerig released two co-authored papers that described the benefits of high frequency trading. Gerig joined, among others, Jonathan Brogaard of Northwestern University's Kellogg School of Business and Terence Hendershott of University of California's Haas School of Business, all of whom extol the virtues of high frequency trading. High frequency trading is empirically shown to have two main benefits: (1) it increases market liquidity; and (2) it reduces trading costs for investors.

High frequency traders are constantly buying and selling shares, which increase market liquidity.[7] Liquidity is the ability of an investor to buy or sell an asset quickly with little price impact to the market. Because so many trades are occurring, buying or selling a stock takes less time than before, and it has less price impact on the market. Through his empirical research at the SEC, Gerig and Daniel Fricke found that "low-latencies [like those from high frequency trading] seem to aid the kind of speculative activity that provides liquidity rather than the bad kind of activity that inhibits the work of liquidity providers."[8] In fact, Gerig and Fricke concluded that their research "demonstrates how low-latency trading can be beneficial."[9] In today's electronic,

[7] Daniel Fricke and Austin Gerig, *Liquidity Risk, Speculative Trade, and the Optimal Latency of Financial Markets*, DERA WORKING PAPER SERIES, note 18 (December 1, 2014).
[8] *Id.*
[9] *Id*. at 19.

algorithm-filled market, an investor can easily locate a willing counterparty to a trade, and that trade has little impact on overall market price. Therefore, high frequency trading has increased market liquidity. With increased cost on the HFT firms to comply with FINRA regulations, HFT firms may not trade as frequently, reducing overall market liquidity.

High frequency trading has also reduced trading costs, which benefits the investor. For many years, market makers and specialists played a role in the price of a security.[10] Today, automated trading algorithms (high frequency traders) have supplanted their human counterparts because automated traders are able to analyze every trade in the market almost instantaneously.[11] By taking in this wider view of the market, automated traders are able to price securities better and more efficiently than a human market maker or specialist can.[12] This leads to better price discovery for an investor and a smaller bid-ask spread, both of which reduce the overall trading costs.[13] The bid-ask spreads are as narrow as they have ever been, and this means better prices for retail investors and lower trading fees for them as well.[14] By imposing more fees, more regulation and more oversight, the SEC will negatively impact HFT firms' desire to trade as frequently. This will send the markets back a few decades, where there will be widder bid-ask spreads, and higher prices for every investors.

As previously mentioned, Austin Gerig, an SEC economist, released two papers on December 1, 2014 that empirically showed the benefits of high frequency trading. No

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[10] Austin Gerig and David Michayluck, *Automated Liquidity Provision*, DERA WORKING PAPER SERIES, note 1 (December 1, 2014).
[11] *Id*.
[12] *Id.* at 36.
[13] Jonathan Brogaard, *High Frequency Trading and Extreme Price Movements* (November 2014) (available at http://modernmarketsinitiative.org/wp-content/uploads/2014/12/SSRN-id2531122.pdf)
[14] Mary Jo White, *supra* April 29, 2014.

doubt, in creating language for the proposed rules, the SEC will have to take into consideration Gerig's findings, and it may limit the SEC's ability to reign in high frequency trading for fear of depriving the market of the benefits of high frequency trading.

Harm to the Intellectual Property of High Frequency Trading Firms

Further, HFT interaction and disclosures to FINRA may be harmful to the HFT firms. Being required to disclose trading strategies and source code for the computer algorithms to the SEC or FINRA is essentially disclosing each firm's trade secrets to the SEC and would greatly increase the likelihood that such trade secrets would be leaked, stolen, or otherwise misappropriated. This in turn would erode each high frequency trading firm's ability to trade, and ultimately destroy the empirically proven benefits high frequency trading has had on the market. Never before has a person or entity trading on his or its own behalf had to register with the SEC and FINRA before trading. To do so would greatly impede the entry of such proprietary traders to the market.

Additionally, being subject to FINRA rules and regulation as a broker would mean that high frequency traders would be required to follow the duties of Best Execution and General Suitability. These duties are generally reserved for brokers who trade on behalf of clients, and as of now, it is unclear how these standards and rules would apply to proprietary trading firms like high frequency traders. This has the potential to muddy the duties that a broker would owe his client, potentially hurting investors who rely on broker's recommendations. The SEC should greatly consider how Best Execution and General Suitability will apply to HFT firms and in particular proprietary trading desks.

Conclusion

As SEC Chair Mary Jo White noted in her speech addressing high frequency trading and dark pools, high frequency trading and trading algorithms in general are not inherently bad; in fact, "many brokers use the same tools on behalf of their customers."[15] So, imposing the costs of FINRA membership on HFT firms would not prevent this strategy from ever being used by financial firms in the market place; instead, it would place an unfair burden on HFT and proprietary trading desks to pay for unnecessary data collection and oversight by FINRA.

[15] Mary Jo White, *Surpa,* New York, NY.