Cato Looks at High-Frequency Trading

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On April 1, the Cato Institute presented a panel discussion titled "High-Frequency Trading: Information Tool for Efficient Markets or Destabilizing Force?" featuring several experts from near and far to discuss a subject that has received heightened attention in conjunction with the publication of the latest Michael Lewis book, which charges that high-frequency trading enables a class of rent seekers to rig securities markets.

Louise Bennetts, associate director of Financial Regulation Studies at Cato, moderated the panel, which consisted of Holly Bell, a professor at the University of Alaska Anchorage, and Hester Peirce, senior research fellow at the Mercatus Center of George Mason University.

Bennetts hastened to assure the audience that the event had been planned long before the release of the Lewis book and the announcement by New York Attorney General Eric Schneiderman on March 18 that his office would be looking into high-frequency trading.

In her introduction, Bennetts suggested there are two ways to look at high-frequency trading. One is as a way to legalize front running; the other is as a constructive tool to reduce risk, reflected in lower trading spreads, and to reduce the volatility of markets. She derided the 60 Minutes interview with Lewis broadcast April 6 as little more than an infomercial for IEX, the exchange the "flash boys" devised as a solution to front running by high-frequency traders.

Bell minimized the significance of the fuss over high-frequency trading, questioning whether it represents a market failure and preferring to classify it as just another form of algorithmic trading, a very old technique, which happens to be employed at the faster speeds that prevail in the world of digital communications. She quoted with approval the theory espoused by Swedish Nobel laureate Eugene Fama that markets reflect available information, so from her point of view, faster speed is presumed to be a benign way of enabling information to operate.

Bell also made a point that could be surprising to high-frequency trading alarmists that the prevalence of this technique has actually declined in recent years. Thus, the share of trading on the NYSE attributable to high-frequency trading has declined from 61 percent in 2009 to 48.5 percent in 2014 (of course, some of it may well have moved elsewhere), the aggregate profit declined from $7.2 billion in 2009 to $1.8 billion in 2012 and spreads narrowed from 6.6 cents to 3.8 cents.

Peirce stressed that there is no need for retail investors "to lose sleep" over high-frequency trading. (The contrary argument would be that they are affected due to their exposure to mutual funds.) Otherwise, she argued that policymakers should study more data and proceed cautiously before proposing new rules to regulate high-frequency trading.

Both Lewis and Peirce espouse a sanguine view of the ability of retail investors to protect themselves by parking their savings in low-cost index funds. I would offer the cautionary note that this is much harder to do than one would expect and that the original source of this idea is the same financial sector that told people that mortgages were a sure-fire way to build wealth because house prices never go down. An even more cynical, therefore possibly more correct, view is that mutual funds are safe because the government is backing them.