

## **Business**

### Deals

# **Declawing Speed Traders Is Goal of Stock Market Revamp Proposal**

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The only way to mitigate the negative effects of high-speed traders is to redesign a key part of how financial markets operate, according to the University of Chicago's Eric Budish.

Trading is now effectively non-stop, with transactions measured in millionths of a second. Budish, an associate professor of economics at the Booth School of Business, proposes to instead segment trading into thousands of auctions throughout the day, preventing the quickest firms from jumping ahead of slower ones. He argued his case last week to the Commodity Futures Trading Commission, the main U.S. derivatives regulator.

The proposal for what Budish calls frequent batch auctions is one of the most extreme ideas for how to improve markets now dominated by automated computerized trading. The academic says it would preserve the useful function that high-frequency traders provide -- generating liquidity -- while eliminating their ability to take advantage of momentary mispricings and profit through pure speed.

"As long as we have a continuous time market, there will be a never-ending and harmful race for speed," Budish said during a phone interview. "If you move to discrete time auctions, then it becomes about price and not speed."

Budish, who co-authored a research paper on his proposal, said he has spoken about the concept to staff at exchange operators, broker-dealers and dark pool operators, high-frequency trading firms and regulators in the U.S. and Europe. He declined to name the organizations because the invitations were private.

## **Malfunctions**

The paper, the latest version of which was published on Dec. 23, also says that auctions through the day could reduce the number of technical malfunctions in the stock market because they would put less strain on systems.

Non-stop markets create a race between speed traders, Budish said. While one high-frequency firm taking advantage of another doesn't seem like a broader issue, those losses are ultimately suffered by longer-term investors who get worse prices, he said.

In the paper written with Peter Cramton of the University of Maryland and John Shim at Booth School, Budish showed the opportunities that exist for speedy traders by looking at the trading patterns of the SPDR S&P 500 ETF Trust and futures on the S&P 500. They found that the price of E-mini contracts often jumps before the ETF, creating the chance for fast traders to make money from buying the fund before the market reacts. While the time shrank from a median of 97 milliseconds in 2005 to 7 milliseconds in 2011, the arbitrage opportunity still exists, the authors said.

### **Concept Release**

There are about 800 such pricing delays between the S&P 500 ETF and E-mini contract each day, and traders who act on them could make about \$75 million a year, the study found.

Auctions would eradicate these opportunities, according to the authors. Under their proposal, bids to buy and sell a stock would be hidden for as long as the auction lasts, and once it's over, those orders that could trade at the determined price would be filled. In a subsequent paper, the authors suggest that the auctions could last anywhere from 50 milliseconds to 1 second.

In September, CFTC members voted unanimously to request industry input on more than 100 questions, including whether to expand testing and supervision of high-speed trading strategies. The concept release, a step prior to a formal proposal by the top U.S. derivatives regulator, also considered ways to limit the maximum number of orders to trade that a firm can place in a given amount of time.

### **Making Case**

Budish presented his case last week at a panel discussion about the concept release during a meeting of the commission's Technology Advisory Committee. The session also included presentations by Stuart Kaswell, general counsel of the Managed Funds Association, Caitlin Kline of Better Markets, and Rob Creamer, chief executive officer of Geneva Trading.

Budish's paper has garnered industry attention, and among the firms he's visited is IEX Group Inc., a dark pool that discourages what it sees as the worst trading practices.

"Eric's idea makes sense if it would be possible for the markets, all venues and all asset classes, to be perfectly synced down to a very granular level of time," Ronan Ryan, chief strategy officer at IEX, said during a phone interview.

However, that's impractical under today's market structure given the extra monitoring and compliance required, he said.

Budish said the study can be a springboard for discussions on how to improve trading.

**Good, Evil**

“If we can focus the policy debate in a more constructive dimension, on market design, and not, ‘Is high-frequency trading good or evil,’ then even if this isn’t adopted overnight we do a lot of good in the meantime for the debate over market structure,” he said.

IEX’s solution to the kind of high-speed games that Budish’s proposal attempts to eliminate is to create a delay of 350 microseconds, or 350 millionths of a second, between when an order is completed and when the market is told.

“This delay both in and out of our market provides the fairest experience for the greatest number of participants and is a departure from what exists in the market today,” Ryan said. “Our architecture design addresses certain predatory HFT strategies while allowing other HFT strategies to trade on the venue without harming participants.”

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