

New EU market rules launch attack against flash trading

The EU Council has adopted new rules for investment services in financial instruments and transactions on the regulated markets in a package known as MiFID-2 (Markets in Financial Instruments Directive) that supersede those of the original MiFID adopted in 2004. The MiFID was designed to regulate transparency and competition in trading activities, ensuring non-discriminatory access to trading venues and CCP (Central Counter Parties) for all financial instruments.

On May 22, the European financial regulator (ESMA) released more than eight hundred pages of consultations describing the technicalities of the revised MiFID. The new MiFID-2 directives includes provisions on the authorization and the protection of investors, they introduce a new type of trading venue (Organized Trading Facility). The timing is somewhat confusing, because this latest version will not be enforced until at least two years from now. In fact, the newest version of MiFID, first drafted in 2007, was adopted by the European Parliament and representatives of Member States in 2010 after almost three years of debate. Its original goal was to enhance the transparency and strength of the European markets, improve the conditions for competition between the different actors while protecting investors.

The purpose of the new rules is to ensure that all organized trading venues take place in regulated markets. The transparency requirements are calibrated for different types of financial instruments, including stocks, bonds, and derivatives and for different types of trading. Trading of raw materials will be controlled by the introduction of limits to prevent market abuse. The subjects of the market must prepare their reports at least every day. Oil and coal derivatives will be temporarily exempted from the obligation of procedures

through the clearing house. MiFID 2 will go further, demanding greater transparency on transactions in bonds and derivatives. MiFID 2 will also adopt ceilings that limit the volume of opaque transactions, setting conditions under which information may be released to be sufficiently clear and accessible as far as prices are concerned. Most importantly, MiFID 2 has targeted so-called High Frequency Trading (HFT). The MiFID-2 will be effective starting in 2015-2016. The technical definition of algorithmic high frequency trading is the subject of several of the 800 pages of the document.

HFT is a recent and increasingly controversial financial 'instrument'. While most traders conduct 'slow' trade, the tool accessible to the vast majority of traders or speculators, high frequency trading, which came to the fore in 2006 and 2007, executes financial transactions at superhuman speed by using computer algorithms. HFT manages market data by analyzing a database inaccessible to 'ordinary' humans and traditional databases. Indeed, the decisions are made by a virtual trader capable of performing operations on the financial markets at unimaginable speed. Such a transaction speed allows traders to perform actions at the best price, which were 20 milliseconds in 2010. In 2011, speed increased to 113 microseconds thanks to advances in technology and communication equipment that makes it possible to trade at nothing short of the speed of light. The problem is that the vast majority of stock investors, worldwide, are trading at far slower speeds because they are targeting long term performance rather than short term gains.

The problem with HFT is that the volume of shares traded by traders, who use this method, is disproportional. Even if the HFT trading volume has increased from at about a third of the total to as much as two thirds in the United States. It has shifted the global stock markets to addressing the needs of HFT traders at the expense of the majority. The dangers of this imbalance were seen in May 2010, when the world witnessed

the first 'flash crash'. During this event, the New York Stock Exchange lost nearly 9.2% for almost 10 minutes. The flash crash is a rapid and unexpected drop in stock prices that can take mere minutes to occur. However, there smaller versions of the flash crash, mini flashes, every week. Since the flash crash of May 6, 2010, related supervisory authorities investigated the phenomenon to ensure the stability of the markets as well as to assess manipulation by flash traders.

The new MiFID rules will certainly affect HFT, subjecting it to stricter controls. Investors using HFT will have to identify the method, because they will be required to advise their trading strategy. Whether, the new regulations will really restore more fairness to the markets is debatable because technological evolution is always a step ahead of the law. Indeed, the EU would actually go as far as to ban HFT; it has chosen to regulate it because it has already faced criticisms from banking lobbies that have already challenged the new MiFID rules. In the United States, the Chair of the SEC, Mary Jo White, has also targeted HFT, proposing to create a category of high-frequency orders that would not be able to compete against, or interfere with, other levels of HFT traders.

Michael Lewis, the most widely read writer on the financial markets, has just published a book 'Flash Boys: Cracking the Money Code' that presents high-frequency trading as the focus of the debate on market integrity and the related battle within the trading world. The new MiFID rules confirm that insiders use technology and other tools to always be a step ahead of the regulators and that ever more sophisticated checks are needed to prevent predatory activity to ensure investors have a safe place to trade.