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In Defense of "Flash" Trading

By Chris Hynes and Donald L. Luskin

For the past several weeks, New York Sen. Chuck Schumer has attempted to intimidate the Securities and Exchange Commission into banning so-called flash trading. Eliminating this technique would be a dangerous mistake that would squash competition and automation in equity trading. Flash trading exemplifies the virtues of two decades of innovation that have improved executions for both individual and institutional investors.

What is flash trading? As pioneered by the electronic communications network Direct Edge, it is simply a way for one customer to query other customers to see if they will take the other side of a trade.

Let's say that among all the exchanges, the highest bid for stock XYZ is 10, and the lowest offer is 10.5. Bob enters a flash order to buy 500 shares in between, at 10.25. This order exists in Direct Edge's system for mere milliseconds, but in that time the high-speed computers of other participants might decide to sell Bob the 500 shares he wants to buy. So Bob gets a price better than the best offer, and the seller gets a price better than the best bid. If a trade can't be executed, then Bob can try other markets.

In this example, because the flash trade comes in between the best bid and the best offer, it does not contribute to market volatility. Buyer and seller have entered into a trade in which they both feel they have achieved the best possible deal, or they wouldn't have traded. And the flash order created an opportunity for new liquidity to enter the market.

Flash trading is like offering to sell your house to your neighbor before you officially put it into the real estate listings. For that matter, it's just like what upstairs traders did in the pre-computer era: shopping an order before sending it to the exchange floor. We had no problem with this process, so why would we ban flash trading, which simply makes it more formal and produces an audit trail that the upstairs traders didn't?

Yet according to Mr. Schumer, in flash trading "a privileged group of insiders receives preferential treatment, depriving others of a fair price for their transactions." The truth is that there's no particular privilege involved. Any broker can enter flash orders or respond to them, even when executing on behalf of ordinary individual investors.

Chris Nagy, managing director of routing for TD Ameritrade, a leading retail broker, has said that his company sees flash trading "working so well that we've increased our utilization of it." It's hard to see how anyone is deprived of a fair price, since a flash trade cannot, by SEC rules, trade through pre-existing orders—that is, it cannot be executed below the best bid or above the best offer.

Mr. Schumer also claims that seeing flash orders allows traders to "act on that early information to trade ahead of the pending orders." Yes, a flash order does reveal information. But so does any order. If flash orders entailed a heightened risk of being front run, as Mr. Schumer claims, no one would ever enter into them.

The real issue here is that innovators like Direct Edge are able to use new systems like flash trading to challenge entrenched institutions like the New York Stock Exchange by attracting their own new pools of liquidity. Innovators profit most when trading is internalized within their new pools, drawing market share away from incumbents. The incumbents typically seek self-protective regulation, characterizing the creation of new pools as "fragmentation" of the equity markets.

In fact, trading innovations do not create fragmentation. They expand the market, drawing in entirely new liquidity that wouldn't have otherwise existed.

Since introducing flash trading in 2006, Direct Edge's market share has soared to 12% from 2%. No wonder, then, that Duncan Niederauer, chief executive officer of NYSE Euronext, said in June that "we're spending a lot of time in Washington." And no wonder that Mr. Schumer has suddenly developed an interest in the microstructure of equity markets.

Competition is what makes America's equity trading system the envy of the world. Let's not throttle it by demonizing the innovations that improve it.

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