ARE HIGH-FREQUENCY TRADING FIRMS GOOD OR BAD FOR INVESTORS?

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On last Friday's "Behind the Markets" podcast, we had a great discussion focused on high-frequency trading (HFT)—a topic that generates emotional reactions among the investor community, with many HFT firms viewed as predators picking off retail and institutional investors alike. The trading ecosystem can be opaque and confusing, and we had a balanced discussion on elements that are good and bad for investors.

Our two guests were Dave Babulak and Alex Sadowski. Babulak founded Blink Trading and grew Blink to 12 people before selling it to Getco in 2002. Babulak was at Getco for 10 years during the electronification of markets, and he brought market-making principles to the trading screens and away from the trading pits and phone call orders. Sadowski was the deputy general counsel at KCG Holdings before it was bought by Virtu; he shared his views on the developments of electronic market making and how he transitioned from being on the legal team at the Securities and Exchange Commission to the legal team of Getco.

A Brief History of the Market-Making Community

Getco was one of the biggest trading and market makers in the United States; at its height, the company represented 20% of all trading volume on all U.S. exchanges.

In 2012, Getco and Knight Capital merged to become KCG Holdings, and KCG became one of the largest market participants until Virtu bought it in 2017.

- **Algos Run Amok:** We discussed how algorithm failures on August 1, 2012, led to Knight and Getco merging and other market incidents where algos were involved, such as the Facebook initial public offering (IPO), the BATS IPO and the flash crash[1].
- **Retail Investors' Liquidity Access:** Babulak discussed why he thinks today's liquidity environment for retail investors is the best ever—with the cost of execution as low as it has been.
- **The Move to Zero-Fee Commissions:** As we discussed commissions going down to zero, Babulak mentioned his reasons for becoming one of first investors in Robinhood, a free trading app that he remains very bullish about.
- **History of Payment for Order Flow:** The group discussed the incentive structure in the marketplace and the pros and cons of payment for order flow in providing liquidity.

- **The Dark Side versus the White Knight:** Depending on whom you ask, high-frequency trading can be either a benefit and liquidity provider or it consists of firms described as front-running other investors' orders. Babulak described a framework for evaluating if certain firms are good or bad, which is essentially if you are providing liquidity and thus selling an option for others to capitalize on. This practice would be providing a bid and ask that people decide to execute on which is value added to the marketplace. At his firm, 90% of his fills were customers choosing to trade with his quotes, so he sees that as value-added liquidity. Other firms were more mixed at 50/50 liquidity provider/liquidity remover, and some firms are 10%/90% as liquidity removers/providers.
- **Amateur Markets in Crypto?:** We also discussed market structure of cryptocurrencies, how the future probably will be more like regular equity markets and how the blockchain is likely to improve efficiency for custody firms over time.
- **Trading Lessons:** The first lesson for investors from Babulak is to use limit orders only. Stop-loss orders become market orders, and when volatility comes in the marketplace there is no guarantee you will have liquidity provided when you need it.

For those interested in learning more about the trading of markets and the liquidity ecosystem, with some also very useful business lessons provided by Babulak at the end, I encourage you to listen to this show.

[1] A market event on May 6, 2010 where the Dow Jones Industrial Average fell more than 1000 points in ten minutes, the biggest such drop in history at the time.

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High Frequency Trading : A fast-speed, high volume trading program that uses algorithms to execute trades based on different market signals.

Bid/Ask Spread : This is essentially the difference in price between the highest price that a buyer is willing to pay for an asset and the lowest price for which a seller is willing to sell it.