RBC On the Markets: Flash Boys Decoded

fwa.org/spotlight/rbc-on-the-markets-flash-boys-decoded/

Written by Tamzin Manning, Director, European Equities at RBC Capital Markets and part of the Global Agenda Committee

With 11 stock exchanges and 45 dark pools in today's market, the complexity of market structure and lack of transparency and disclosures has caused public concern and is highlighted in Michael Lewis' latest book, Flash Boys.

The FWA's newly created "RBC on the Markets" annual series sheds some light on the topic and the event, Flash Boys Decoded, featured some of the most influential voices across the industry on the subject of market structure including Brad Katsuyama, CEO of IEX and the main character in Flash Boys; Robert Grubert, RBC Capital Markets' Head of U.S. Equities; Jennifer Hadiaris, RBC Capital Markets' Global Head Market Structure Strategy; and Matt Lyons, Senior Vice President at Capital Group.

The panel of experts spoke to a standing-room-only audience of 150 at the Harvard Club and explained what some popular terms mean. Here is what you need to know.


Panelists address attendees at the Harvard Club

- What are Dark Pools?
  Dark pools match buy and sell orders, just like an exchange. However, unlike an exchange, dark pools don't display orders, so there is no 'pre-trade transparency' into whether or not there are buyers or sellers in the pool, what prices they are willing to trade at, or how large their orders are. So participants enter orders looking to find a 'match' without having to display their order to the markets and risk leaking information about their order that other people can use to trade ahead of. Some dark pools were initially started to help institutional investors protect their larger orders. Displaying large orders increases the risk other firms will trade ahead of them, which could lead to an inferior price for the institution. Institutions were looking for a place to trade big portions of these larger-sized orders without displaying them to the public. They can enter large orders in dark pools without the risk of anyone knowing the orders are there before they execute, reducing the risk of information leakage. In addition dark pools represent a significant and important source of liquidity.
- What is High Frequency Trading?
  The panel quoted investor David Einhorn on HFTs (High Frequency Traders) causing 'diffuse harm' for investors and 'concentrated benefit' for the HFTs. High frequency trading refers to automated proprietary trading strategies that are dependent on low-

latency technology to execute rapid short-duration orders. HFT strategies typically make execution and routing ‘decisions’ and derive profits based on latency-sensitive information. HFT accounts for around 50% of US market volume. We believe there are adverse HFT strategies in the market that are harmful for institutional investors. These strategies derive profits from signals and patterns that institutional investors can leave in the market. There are also more ‘benign’ or non-predatory trading strategies like automated market making that have naturally evolved as traditional roles in the market have been replaced by automated strategies. These strategies largely derive profits from capturing the spread while providing liquidity. As long as these strategies exist, it is incumbent on broker dealers to understand these strategies (both predatory and non-predatory) and the evolving market structure in which they exist in order to protect institutional client orders.

Networking, one of the key benefits of membership with the FWA, continues to prompt new relationships and deepen current ones

- What is IEX?
  IEX (Investors Exchange) is an Alternative trading system (ATS) which opened in October 2013. It is currently a dark pool but has announced plans to become a registered exchange. Like a stock exchange, IEX matches buyers and sellers. It is owned exclusively by a consortium of buy-side investors, including mutual funds, hedge funds, and family offices, and IEX has been focused on creating a market model where participants cannot take advantage of structural inefficiencies in the market to disadvantage other participants. IEX has worked to neutralize the harmful aspects of HFT through their technology. IEX does not allow co-location, which is when HFTs place their computers right next to an exchange or dark pool to receive trade and quote information faster than other participants. Without co-location, HFTs have to wait to receive notification that they executed an order on IEX. This means they do not have time to cancel orders elsewhere based on a fill in IEX. Essentially, HFTs are allowed in IEX, but the more adverse strategies (including where HFTs place orders just to receive execution signals and trade ahead of them) are neutralized.

Special thanks to President’s Circle Sponsor RBC and the Global Agenda Committee!