31 July 2014

Mr Martin Wheatley  
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Dear Mr Wheatley

Regulation of high-frequency trading

In a one-off evidence session on 22 July 2014, the Economic Affairs Committee heard from Brad Katsuyama, president and chief executive of the US equity trading venue IEX. Mr Katsuyama discussed his experiences of the US equity markets, particularly the opportunities that high-frequency trading has created for predatory practice.

In a speech on high-frequency trading in June 2014, you compared today’s trading conditions with those of the nineteenth century, noting that while horses have been replaced by fibre optics, the “race for speed” has not changed and the broad issues remain the same.

The Committee put this point to Mr Katsuyama. He believes that there is a difference, the race today “is not really between high-frequency trading participants and slow manual traders; it is between high-frequency trading and the market centres themselves…you now have an extreme situation where the fastest participants are faster than the New York Stock Exchange”. He thought markets today were “unfair” because trading venues, by selling technology to high-frequency trading firms, are no longer neutral: “an entire infrastructure has been built around unfair trading.”

An argument often put forward in favour of high frequency trading is that it provides greater market liquidity. Mr Katsuyama highlighted a recent paper by Albert Menkveld and Marius Zoican which concluded that speed does not necessarily improve liquidity. Looking at the NASDAQ-OMX exchanges in Copenhagen, Helsinki and Stockholm, the paper found that when there was a tenfold increase in the speed of those markets, bid-offer spreads from market-makers actually widened by 32%.

We note that revisions to the Markets in Financial Instruments Directive will be implemented in the UK in two years time. You have described these changes as bringing in “a long, and complex list of new rules.” Mr Katsuyama thought that it would be difficult for
direct regulatory action to prevent predatory trading or market volatility: “every prevention technique really addresses the problem that just happened, not necessarily one that may happen in the future.” Instead, he advocated more transparency and disclosure for trading venues, believing this would help stop predatory practice.

Do you believe that predatory trading is an issue in UK equity markets? If so, how does the Financial Conduct Authority think the issue should be best tackled? The Committee would also be grateful for comments on Mr Katsuyama’s thoughts as outlined above.

Hollick
Chairman, Economic Affairs Committee