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Viewpoint: Reto Francioni

High frequency trading and the stock exchange

It would almost appear that new facts have emerged to which the general discontent with the financial sector can be attached. High frequency trading, or HFT, is under intense with more or less appropriate arguments. The debate about high frequency trading in Germany has become more heated in the past few weeks. There have been many questions – often quite justified – as to the benefits of HFT for the German economy. Equally, members of an open society have a right to raise such questions – and those on whose systems these trading technologies are executed have an obligation to participate in this discussion.

The term HFT was coined in 2006. Speed has always been a factor in competition but has become increasingly important in electronic markets. Electronic markets have a significant advantage over trading-floor systems in which broker orders are executed via open outcry. They offer practically unlimited transparency for all market participants and, in this manner, prevent individual traders from exploiting lacking transparency for themselves. HFT is a technology that uses the information available on the market to the highest degree possible. One result is that liquidity rises, benefitting companies listed on the stock exchange as well as investors.

High speed electronic trading, which also enables order execution based on mathematical calculations now constitutes a considerable proportion of stock exchange trading. This form of trading currently constitutes around 40 percent of the total number of transactions executed on Xetra, Deutsche Börse's electronic cash market. This large proportion underscores the fact that HFT operators make a major contribution to pricing and capital allocation on publicly accessible markets.

What are the objectives of traders that use HFT technology?

1. Liquidity suppliers are by far the largest group using HFT. They provide the market with tradable buy and sell offers (quotes) and generate profits on the difference between them – the bid/ask spread.
2. Arbitrage traders capitalise on the valuation differences that arise for short periods of time between economically identical or similar products.
3. The third category comprises momentum traders who reap profits by quickly reacting to new information surfacing on the market.
4. Finally, there are traders that draw conclusions on the direction market development will follow by analysing order volume movements on the markets.

Traders only make a profit with these strategies if they actually trade; i.e. conclude transactions. Fake orders are not successful. Moreover, Deutsche Börse already introduced a ratio several months ago, which resulted in higher fees being charged when a certain number of orders placed to trades actually executed is exceeded. This has proved to be an effective measure to prevent participants from manipulating the exchange trading system.

A number of studies have demonstrated that HFT plays a major role in increasing liquidity in securities trading, including some by the Commission of Stock Exchange Experts (*Börsensachverständigenkommission*) appointed by the Federal Finance Ministry. A greater liquidity supply lowers volatility on the markets, i.e. the fluctuation in share prices. Of course all investors, as well as the real industry, benefit from having more liquidity and the consequent better price quality.

Now, people not only acting in the capacity of trader can cause imbalances in the markets by making erroneous order entries. And due to programming bugs, they can also activate algorithms that do not work as they should. Because of the high speed, the system errors triggered can generate an explosive impact – but only if the trading systems have no security mechanisms.

Comprehensive and tried and tested security mechanisms have always been and remain a fixed component in the trading system of Deutsche Börse's cash market Xetra. Importantly, there is also an automatic volatility interruption for each security. This function ensures that the trading system automatically halts continuous trading and triggers an auction as soon as the execution price lies outside a dynamically adjusted range. This gives every market participant that has invested or plans to invest in this security time to place, cancel or change his orders. It also prevents the dangers that result from falsely entered orders. The advantages of regulated exchanges over non-regulated pricing processes can also be seen here.

In this context, Deutsche Börse Group also welcomes the draft legislation on the prevention of dangers and abuses in high-frequency trading recently published by the German federal government. This draft essentially provides for expanding supervisory rights as well as obligations for trading platform operators and trading participants. In terms of implementation, it is important that the law also be applied to alternative trading platforms (MTFs). Deutsche Börse remains committed to its principles of transparency, neutrality, increasing market integrity and systematic market supervision.

In conclusion, HFT per se is a development which continues to advance the function of stock exchanges for listed companies, the economy and investors. It does, however, require a high level of competency, strict application of rules and a regulated platform.