

## Wall St might not be ready for a war on high-frequency trading

Written by The Conversation

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Stock markets globally have seen increased fragmentation in recent times as investors seek [lower transaction costs](#), faster execution time of trades and fairer prices.

Now a startup backed by US entrepreneur Eric Ries and some Silicon Valley supporters have initiated talks with the Securities and Exchange Commission (SEC) for a new type of trading venue, dubbed the Long-Term Stock Exchange (LTSE). But could the plan create more problems than it solves by taking aim at high-frequency traders?

The talks come as the SEC last week [approved](#) another new exchange, the [IEX \(Investors' Exchange\)](#), which aims to create a more level playing field for investors by slowing down high-frequency trading by 350 microseconds.

Whilst the IEX focuses on protecting investors, the LTSE is motivated by younger firms seeking an investor-base who are in it for the long-haul. It's also designed to shield such startups from short-term volatility in prices due to earnings numbers and fast-traders, better-known as high-frequency traders.

High-frequency trading is considered bad by some as it can reduce [market stability](#) (as seen during the 2010 Flash Crash) and front-running strategies, which increases trading costs for other investors.

Key features of the LTSE include: using the length of time that an investor has held shares to determine shareholder's voting rights, linking managers' pay to long-term performance (similar in nature to issuing stock-options as a form of manager compensation) and more detailed disclosure regarding capital expenditure.

### A difficult road

On the surface the LTSE may seem like an attractive prospect, but a number of challenges stand in the way before such an exchange can become a reality, in particular the role of

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high-frequency trading and order-protection rules.

An important aim of the LTSE is for listed stocks to have sufficient liquidity (i.e. ease with which you can buy or sell assets). Other aims include fairer prices, as well as allowing stocks to co-list on other US exchanges, all while shielding stock prices from high-frequency traders.

There is ongoing debate regarding whether high-frequency traders are good or bad for markets. But high-frequency traders reportedly account for more than 50% of total trading in US markets. This means they are a key player in supplying liquidity and their quoting activity is a primary mechanism through which [prices reflect information](#). The exclusion of HFTs from the LTSE could have serious implications for [liquidity](#).

Finance theory teaches us about the law of one price – that is, the same asset should sell for the same price at all locations. The lack of price discovery and trading activity from high-frequency traders may result in unfair prices for LTSE listed-stocks when compared to their cross-listed counterparts.

If LTSE prices are inefficient, order protection rules introduced [by the SEC](#) in 2007 will re-route trades to alternative exchanges to ensure investors get the best price. The potential for unfair prices and lack of liquidity could outweigh the short-term volatility induced by high-frequency traders that supporters of the LTSE wanted to eliminate in the first place.

Then there's the question of which firms will be brave enough to first list, how much it will cost to list, and whether there is enough demand for the LTSE to survive.

### A long-term proposition

While trading is beginning to take place away from traditional exchanges around the world, for example in Canada and Europe, there's still a lack of connection between different trading venues. This will make it difficult for the [advantages of US market fragmentation](#) to materialise in other markets, such as from the introduction of a LTSE.

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Ries [first proposed the LTSE concept in 2011](#) . Given the multitude of challenges that exist it could be many more years before we see a LTSE. One only has to look at the red tape and controversy surrounding the [IEX Group](#) to see the speed humps to innovation.

*Vinay Patel does not work for, consult, own shares in or receive funding from any company or organisation that would benefit from this article, and has disclosed no relevant affiliations beyond the academic appointment above.*

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