High Frequency Trading's Social Utility

The New York Times reported yesterday that regulators around the world are examining High Frequency Trading (HFT) with a view to curbing its influence over short term market moves. The use of computer algorithms to execute short term trading strategies has resulted in physical proximity to stock exchanges being valuable so as to reduce latency in the transmission of orders. In other words, reducing the time that electronic pulses take to reach their destination can have a meaningful impact on results.

There is an assumption among stock market regulators generally that increased volume is a good thing. Higher volume causes increased liquidity and, so the argument goes, lowers the cost of transacting for everybody. It's generally not an unreasonable view, and the corollary is that the cheaper is it so trade, the better off are both the savers who put money in the market and the companies who acquire those savings through equity issuance. In fact, for all the focus on short term swings in the market it's as well to remember that its ultimate purpose is to channel capital from savers to where it can be usefully invested in productive ways. That is the point, after all, of a stock market and at its most fundamental every related activity ought to be geared to promoting that outcome.

Regulators don't currently expose every new trading strategy or activity to that litmus test. Perhaps that's as well. But HFT does seem to be about as far away from channeling savings to useful places as it's possible to be. The New York Times article mentioned above goes on to note how firms routinely post thousands of orders at a time, only to cancel many of them a split second later. Firms have been fined for trying to manipulate the market through the sudden appearance and disappearance of large orders. HFT was blamed by some for the “flash crash” on May 6, 2010.

So ask yourself if the world would miss High Frequency Trading if it just disappeared from the landscape. Who would care, other than the traders themselves and (presumably) the providers of the trading capital they use. Would stock market returns be lower? Would the cost of raising equity capital be higher? It’s doubtful.