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Schumer: SEC to ban flash trading

Trades that flash in milliseconds provide an advantage to select investors

By Ronald D. Orol, MarketWatch

WASHINGTON (MarketWatch) -- Sen. Charles Schumer, D-N.Y., said Tuesday that the Securities and Exchange Commission plans to ban so-called "flash trading," where high-frequency traders can get information just before it becomes public.

"We salute the SEC for moving forward with this ban that will restore integrity to the markets. The agency is absolutely making the right call by stepping up and ending this unfair practice," Schumer said.

Flash orders are trades that flash in milliseconds to only a select group of market participants which can disadvantage other investors. Traders with access to the information because of super-fast computers can act on it quickly to trade ahead of other traders, influencing the pricing of stocks.

SEC Chairwoman Mary Schapiro indicated in a statement that the agency is considering a measure that would ban flash trading, however such a move would need to be approved by the agency's five-person commission.

Schapiro said that earlier this year she asked the SEC staff to conduct a review of flash orders by exchanges and electronic trading systems.

"Since that review was undertaken, I have asked the staff for an approach that can be quickly implemented to eliminate the inequity that results from flash orders," Schapiro said. "Under the rule-making process, such a proposal to eliminate the ability to flash orders would need to be approved by the commission and be open to public comment."

She added that the agency is also examining private electronic markets operated by brokerages that don't publicly post quotes.

Schumer said Schapiro assured him of the imminent ban. The senator cited an industry estimate that high frequency trades accounted for $21 billion in profits in 2008.

"Flash orders allow sophisticated high-frequency traders to gain access to trading information before it is sent out widely to other traders," Schumer said. "For a fee, the exchange will 'flash' information about buy and sell orders for just a few fractions of a second before the information is made publicly available."

Joe Saluzzi, co-head of equity trading for Themis Trading in New Jersey, said he is happy the SEC appears to be taking steps to ban flash trading.

"We're very happy to hear that the public's concerns about flash orders have been addressed," Saluzzi said.

He added that high frequency traders represent 70% of the volume of trading on most days, which exchanges rely on heavily for their fee generation. Saluzzi argues that high frequency traders typically threaten to leave one exchange for another if they do not get special advantages for their volume of transactions.

"Once this is approved, high frequency traders will likely start screaming to the exchanges that 'you better find me something new' or they will leave again," Saluzzi said. "But flash trades are just one of their tools."

Jamie Selway, managing director at White Cap Trading in New York, said flash trades are unfair because they create a private market for some transactions, however he did not believe banning them would have any major impact on the volume of trades in the markets.

"There is a private set of prices that are better than those available in the public markets," Selway said. "However banning it won't have a big impact."

Location Location Location

Saluzzi added that he hopes the SEC and Commodity Futures Trading Commission take steps to limit the practice of co-location, where large volume high-frequency traders are permitted to place their servers in an exchange's data center. CFTC Chairman Gary Gensler discussed issues around co-location at a recent agency hearing on speculation in the energy markets.

"Physical proximity is everything," said Saluzzi. "If the wire is shorter, it means everything."

However, Saluzzi said he believes regulators are worried that if high frequency traders have many of their special advantages removed the result could be a major reduction in the volume of trades.

"They can disappear tomorrow," Saluzzi said. "If you take away too many of their tools, the volume of trades may dry up."

Selway added that eliminating co-location would significantly reduce the volume of trades in the markets. "These people live or die by a millisecond," Selway said. "If you get rid of co-location you get rid of the volume in the markets, which would hurt liquidity."

Just tip of the iceburg

Sen. Ted Kaufman, D-De., said he was pleased about the flash trading step but said it was only one of a number of things the SEC could do to limit unfair practices that could have a negative impact on the markets.

"We seem to be learning more every day about certain order types, high-speed trading, collocation of servers at exchanges, dark pools and other indications that we have a two-tier market: one for privileged insiders with high-speed computers and another for the average investor who must follow the rules," Kaufman said. "We need the SEC to move with urgency to restore investor protections and thereby strengthen the credibility and integrity of America's financial markets."