ONE CAPITAL
MANAGEMENT, LLC

Folio

Spring 2014

Flash Controversy

In the late 1700s, Nathan Rothschild, headquartered in London, had each of his four brothers stationed in major financial centers around Europe in order to increase their money changing business. When the Napoleonic Wars began, the family developed a network of agents, shippers, and couriers to transport gold across the war-torn continent. The system also provided Nathan with something more valuable-advanced information. Now a huge player in the London Stock Exchange, Nathan used this private information, which others, including the government, often wouldn't receive until days later, to gain an advantage in the markets.

Were the Rothschild's actions shrewd or unethical? Either or both, depending on how one looks at such things. But the family wasn't doing anything criminal. And they hadn't rigged, by any definition of the word, the London Stock Exchange.

Which brings us to the hoopla surrounding Michael Lewis' *Flash Boys*, the claim made by the author that the market is rigged, and what this all means for OCM's clients. If you've missed the media coverage on "60 Minutes" or in the *New York Times Magazine*, among scads of other outlets, the book exposes a method used by "high frequency traders" (HFTs) to exploit market inefficiencies. What hasn't been mentioned much or at all is the great irony-these inefficiencies may have been caused by well-meaning regulators trying to help the average investor.

In 2002, brokerage houses and investment banks were required to seek the "best execution" reasonably available for their customers' orders. To comply, according to the SEC, "brokers evaluate the orders they receive from *all* customers in the aggregate and periodically assess which competing markets, market makers, or electronic communication networks (ECNs) offer the most favorable terms of execution." Orders typically took a few seconds to a few minutes to be filled. By 2005, the ubiquity and efficiency of electronic trading systems had eliminated people, and orders were processed *almost* instantaneously. Because of this, regulators began to focus nearly exclusively on speed as the basis for "best execution." Meanwhile, larger electronic orders started (quickly) bouncing around to different exchanges searching for the best price.

HFTs like the ones in Lewis' book saw opportunity here. They armed themselves with faster technology than those placing the orders. Once they saw a large quantity of, say, GE bouncing around looking for the best exchange, they'd send their order, which would arrive milliseconds before, reprice the security slightly higher, and make a small individual gain. Done millions of times per day, the aggregate profits were enormous. These HFTs aren't doing Wall Street's image any good. The practice is infuriating, for sure. Even unethical, perhaps. It's also legal. And doesn't constitute "rigging" the markets. And while new regulations and criminal investigations have been proposed, we don't believe those are the answers.

When the Rothschild family's network became public knowledge, the playing field wasn't leveled by adding regulations or prosecuting Nathan and his brothers. The problem was solved by understanding the inside track they'd obtained and making it available to all who participated in the market. An advantage that can be exploited by all ceases to be an advantage. We believe in the transparency of information and Lewis' book will lead to new methods and technologies that will help eliminate the practice. (And, of course, another group will go to work trying to gain an edge in other ways. The cycle will continue.)

Lewis and others claim the HFT's behavior affects us all. And to some degree, they're right. But we're confident it hasn't and won't affect our clients. The small orders we make don't bounce between exchanges or trigger HFT trades. If an order can be filled at the primary exchange, no additional order is needed. And when we place

larger trades, we are mindful of liquidity and available quantities in the marketplace. If we don't see sufficient price or size available, we use "limit orders" to set the price we are willing to accept. This takes away the ability to move ahead and change our price. To date, we haven't seen any trade that wasn't executed as expected when sent across our electronic system.

On behalf of our clients, we always seek best execution of transactions. Best execution is the execution of securities transactions for clients in such a manner that the clients' total cost or proceeds in each transaction is the most favorable under the circumstances.