

# Industry Fears Proposal in Congress Would Destroy High-Frequency Trading and Liquidity

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By James Ramage

Trading industry experts said the passage of a new bill to tax each buy and sell transaction by up to 25 basis points would devastate liquidity in the equities market.

The proposed House of Representatives' bill-H.R. 1068: Let Wall Street Pay for Wall Street's Bailout Act of 2009-would, they say, dramatically increase trading costs, widen bid-ask spreads, kill off high-frequency market making firms, slash volumes and move trading to overseas markets.

"It would have a really major impact for the high-frequency players," said Jeff Bell, with Wedbush Morgan Securities' clearing and technology group. "It would end that whole business."

Since equities began trading in penny increments in 2001, the trading industry has undergone a massive overhaul, moving to an electronic trading world. Today, roughly 65 percent of all volume is executed by high-frequency traders, who have replaced specialists and market makers who fled the inside market due to narrower bid-ask spreads that raised their risk profile.

The concern within the trading industry is that if high-frequency traders were taxed, they would exit the business, because their current razor-thin margins would turn to losses. The result? Liquidity would disappear for all market participants.

Wedbush clears the trades for many of the industry's largest high-frequency firms. Bell calculated, for example, that Wedbush's fee for the tax would have been more than an estimated \$50 million on Monday alone for having done more than \$20 billion worth of securities transactions that day.

"That's a huge tax; 25 basis points is enormous," said Dan Mathisson, the head of Credit Suisse's Advanced Execution Services.

The proposed bill would add 5 cents per share to the cost of trading an average stock, at around \$20 a share, Mathisson added. By comparison, electronic trading commissions for services cost a penny-or just under a penny.

"You're talking about raising the trading costs more than five times," he said. "That would bring liquidity presumably down to levels from 10 years ago, which is the last time transaction costs were that high. I assume you would see volumes drop from about 10 billion shares a day to one billion shares a day."

Details for the bill have yet to be worked out. As written, the bill would amend the Internal Revenue Code of 1986 to impose a tax on certain securities transactions enough to recoup the net cost of the Troubled Asset Relief Program. Rep. Peter DeFazio, D-Ore., authored the bill.

DeFazio introduced the bill on Feb. 13. It has since been referred to the House Committee on Ways and Means, according to the House of Representatives' Web site.

The bill's findings argue that because the \$700 billion TARP fund and the new Federal Reserve lending facilities were created to protect Wall Street investors, the same Wall Street investors should pay for the infusion of taxpayer money.

"The easiest method to raise the money from Wall Street is a securities transfer tax, a tax that has a negligible impact on the average investor," the bill states. "This transfer tax would be on the sale and purchase of financial instruments such as stock, options and futures. A quarter percent (0.25 percent) tax on financial transactions could raise approximately \$150 billion a year."

The offices of Representatives DeFazio and Michael Capuano, D-Mass.-the only one of seven additional sponsors of the bill who is on the House's Financial Services Committee-did not return calls for comment.

There is precedent for such a tax. The United States imposed a transfer tax of 0.2 percent on stock trades between 1914 and 1966. In addition, investors now pay the federal government \$9.30 per million dollars of face value to fund the Securities and Exchange Commission-under Section 31 of the Securities Exchange Act of 1934.

With such a steep climb in transaction costs, high-frequency market makers operating on razor-thin margins would be the first to fall, several in the industry said. By some accounts, they comprise an estimated two-thirds of average daily volume.

And with less liquidity, by definition, spreads would widen, said Eric Hess, general counsel for Direct Edge ECN. They could widen by a factor as great as three or four, according to some estimates.

"It would have a cascading effect over time," Hess said. "In the same way that liquidity begets liquidity, draining liquidity has the tendency to drain even more liquidity."

The extra cost would most likely get passed on to investors. Because of tight margins, broker-dealers wouldn't assume the cost themselves, unless they were for their own proprietary accounts, Hess added.

The Security Traders Association circulated a letter to its members earlier this week that described the tax's potential impact. In it, the letter laid out the bill's impact on high-frequency market makers and overall liquidity in the equities, options and futures markets.

"The deeper and more liquid the market, the better the price discovery and related information provided," the STA letter said. "Impairment of liquidity lessens the value of the information and the functioning of a market-based economy."

And with less liquidity, firms would be encouraged to trade overseas, where costs are cheaper, Hess said. Consequently, more companies could be encouraged to list overseas.

As many stocks can be listed overseas, the tax would create an immediate market for them. Market venues such as the Toronto Stock Exchange and or Chi-X, in Europe, could likely start listing U.S. equities, some industry pros said.

Mathisson laid out one scenario.

"How long does it take for off-shore entities, such as the Chi-Xs of the world, or the London Stock Exchanges of the world, to cross-list a significant number of U.S. companies and get everybody to start to trade there?" he asked. "And then volume in the U.S. would drop even more, or maybe just stop. Maybe the U.S. equities are traded at exchanges overseas. And then the [transaction] tax generates a negligible amount of revenue because it shuts down the U.S. exchange industry."

The bill won't generate the anticipated revenues if trading behavior changes and volumes plummet, Hess added.

"You're talking about imposing a tax on behavior that can change overnight and over time," he said. "Algorithms will be changed. Trading patterns will be changed. People will seek to minimize the impact of this tax on them and that will result in less revenues, not to mention the additional costs it will impose on an already fragile system."

Many of the half dozen in the industry pros interviewed for the story said the bill was too obviously flawed to pass. But each added that in an environment where the entire financial world is blamed for banks' ills, and many are desperate to close budget gaps, no one is sure how seriously the bill will be taken.

"It's better to be proactive on a poorly designed investor tax than it is to sit and wait for it to pop up on the mainstream radar," said Peter Driscoll, current STA chairman, and senior equity trader at The Northern Trust Co.

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