



AN ANALYSIS OF GLOBAL HFT REGULATION Motivations, Market Failures, and Alternative Outcomes

Recent market events like the “flash crash” of 2010, algorithmic failures at Knight Capital, and the release of Michael Lewis’s book *Flash Boys* (2014)—with his claims that markets are “rigged”—have heightened scrutiny of high-frequency trading (HFT) and increased demands for more aggressive regulation. However, HFT has several empirically demonstrated benefits, and the current, largely qualitative arguments against it call for careful scrutiny of proposed regulations.

In a new study for the Mercatus Center at George Mason University, [Holly A. Bell](#) and [Harrison Searles](#) analyze the potential economic benefits of HFT and assess several proposed or adopted regulatory schemes from around the world.

For the complete study, see “[An Analysis of Global HFT Regulation: Motivations, Market Failures, and Alternative Outcomes.](#)”

BACKGROUND

The study surveys the global HFT regulatory environment, and includes an analysis of the intended goals of regulators within each country. Countries and regions chosen for review meet at least one of the following criteria: they have a major HFT market, have recently implemented or proposed significant HFT regulation, or have an emerging HFT market.

The study describes the goals of HFT regulators as falling into two broad categories:

- *Shared (or market integrity) goals.* These goals are shared by traders, exchanges, and regulators. They include market integrity factors such as secure, reliable, and orderly markets that enable effective price discovery and limit manipulation and abuse.
- *Divergent (or “fairness”) goals.* These goals are not necessarily shared by traders, exchanges, and regulators. They include perceptions of “fairness” and the generation of tax revenue. Particular regulatory strategies and tactics proposed to accomplish divergent goals include slowing down or eliminating HFT, implementing financial transaction taxes, reducing order-to-trade ratios, discouraging short-term trading while encouraging long-term investing, and requiring algorithms to continue trading regardless of market conditions.

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FINDINGS

- There is little evidence that a market failure exists requiring additional aggressive regulation of HFT, or that government intervention will achieve market integrity or “fairness” goals better than existing market incentives.
- Empirical evidence shows that HFT reduces trading costs, provides better investment performance for long-term investors, improves liquidity, and offers more flexibility and options for smaller retail investors.
- Countries implementing policies that curb the use of HFT have experienced diminished liquidity.
- Many regulatory proposals have unclear definitions of HFT that fail to differentiate it from algorithmic trading and other technology-driven markets.
- A number of existing regulations and cooperative nonregulatory solutions are in place to ensure the integrity of financial markets where HFT is used. These include circuit breakers, HFT neutralizing algorithms, and erroneous order detection systems.

RECOMMENDATIONS AND CONCLUSIONS

- Regulators that seek to govern HFT activities should clearly define the activity they intend to regulate; otherwise such regulations could have unintended consequences for financial markets as a whole.
- Aggressive HFT regulations in certain markets could push financial activities and capital into growing and emerging HFT markets, such as those of Japan and Singapore. Therefore, regulators should be careful to gather empirical evidence of a market failure before enacting new regulations targeting HFT.
- Regulators should be wary of implementing HFT regulatory policies designed to standardize market integrity practices. Such measures could potentially hamper risk management innovation and create a punitive environment that discourages public self-reporting of system or trading problems.