Remarks on High-Frequency Trading & Insider Trading 2.0
New York Law School Panel on "Insider Trading 2.0 – A New Initiative to Crack Down on Predatory Practices"

Remarks as Delivered

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Thank you very much. Thanks, Dean Crowell, for that kind introduction. It's a pleasure to be here with you today. I want to particularly thank the New York Law School Center for Business and Financial Law and the Center for New York City Law for hosting this event.

I have spent a lot of years working in these areas. When I first graduated from law school, I was a law clerk a few blocks away in the Federal District Court, and I practiced in and around this environment for very many years, and I'm glad to see the school flourishing.

I am joined today by some members of my staff, particularly the head of my Investor Protection Bureau, Chad Johnson, who will participate in the panel that's going to be coming after I speak.

As your Attorney General, I am the top law enforcement officer for the State of New York, which gives me a unique role to play in the oversight of Wall Street. And I take that very, very seriously. I spent most of my career in private practice before becoming Attorney General, which is really a distinction among Attorneys General in New York State. And I represented big financial firms; I represented stock and commodities markets.

And I am a believer in our market system, and I am a believer that our market can only function with strong, clear regulations, and uniform and equitable enforcement of those regulations.

We have to ensure that our markets work for the entire investing public, not just for a small number. And the Martin Act, which I hope you've heard of, empowers my office, and our Investor Protection Bureau in particular, to investigate pretty much any fraudulent or deceptive practice in financial dealings.

One of the fundamental principles that drives every part of our office is a very simple, very American notion of equal justice under law. There has to be one set of rules for everyone.

That doesn't mean we guarantee anyone success. That doesn't mean everyone will win in the markets. Investors have the right and the ability, and managers have the right and the ability, to compete through any legal process.

Our markets are not designed so that we expect people to take public interest into account when they're deciding how aggressively they're going to push for something. If you buy stock, you want them to go out and make money.

But this is where the rules and regulations come in. We have to protect our markets to make sure that no one starts out with an unfair advantage or games the system in a way that harms people who are putting their hard-earned dollars into our markets.

And I hope everyone here appreciates that I, as a fan of the markets, believe that our capital markets, our stock and commodities markets, are unique in the world. We have to preserve them and protect them with clear regulation and law enforcement.

Over the last five years in the U.S., we have invested over $140 billion in startup businesses. That's five times the investment of all the capital funds and venture capitalists in Europe, and almost five times the investment in all the rest of the world.

This is one of things that makes us unique. It is a critically important part of our lives as Americans, and a critically important part of our lives as New Yorkers.

But, as I mentioned, our capital markets can only succeed if investors view them as fair and as fairly regulated.

So that's why we've been focusing on cracking down on fundamentally unfair – and potentially illegal – situations that fall outside the parameters of traditional insider trading but give elite groups of traders access to market-moving information at the expense of the rest of the market.

This is what we call Insider Trading 2.0, and it's one of the greatest threats to public confidence in the markets.

This isn't about some Gordon Gekko-like characters gobbling up companies using information about those companies that no one else has. In some ways, it's more insidious, because this new breed of predatory behavior gives small segments of the industry an enormous advantage over all other competitors and allows them to use new technologies to reap huge profits based on very, very minor, but nonetheless unfair, advantages.

And that's why, last year, we launched our effort at calling out, identifying and trying to do something about Insider Trading 2.0.

It is evident to anyone who's working in the markets, and certainly to people like me, who've been around for a very long time observing the markets, that technological advances in recent years have transformed our system. Most of these changes are for the better. But some of those advances have also opened the door to new types of abuse and unfair practices in the markets.

Last summer, for example, we learned that Thomson Reuters was letting high-frequency traders pay a premium – actually, they had two levels, one group was paying a premium, another other group was paying an extra premium. That latter group had a two-second advantage in getting a peek on – this not even information that is specific to a company, it's just what the survey of consumer confidence from the University of Michigan showed. Just public sentiment. But with that two-second advantage, they were able to move the markets.

To their credit, Thomson Reuters did the right thing once we confronted them about this and stopped selling that two-second edge to a small portion of high-frequency traders.

We also cracked down on predatory front-running schemes – again, only possible because of new technology -- in which large funds were conducting global analyst surveys. They were designed, timed and structured to allow those funds to obtain information from analysts that told them what was going to be in reports that had yet to be issued. It's unlawful to issue reports to some and not others, but they were asking questions before the reports would come out so that they could see what was going to be coming out, and front-run the market.

We got several firms to stop doing analyst surveys, including our friends at BlackRock, who really did lead the way on this, and we eventually persuaded all the major firms on Wall Street employing analysts themselves to prohibit their analysts from participating in any surveys of this kind.

So, this year, it came to our attention that high-frequency traders were getting an edge on the rest of the market through subscriptions to wire services that distribute, again, market-moving corporate announcements. Keep in mind, high-frequency traders do not care if information is accurate or inaccurate. They just want to know what's coming out on the market that might sway public sentiment.

So this is very different than traditional insider trading, where they'd say, "Okay, we know Exxon's about to strike oil in Alberta." That's actual information. This is all just about what might move the market, because they're in and out in milliseconds. They don't really care about the long-term effects of the information.

So these wire services were getting money, publicly traded companies being legally required to provide their key information to the investing world at the same time. Most companies contract with wire services like Business Wire to distribute their market-moving information, and most people get that information through news aggregators like Bloomberg and Dow Jones.

What we learned was, these major services were selling subscriptions directly to high-frequency traders, who were seeing the information a split second earlier than investors relying on services like Bloomberg and Dow Jones – and that was enough, again, for them to move the markets.

So, after discussion with our office's Investor Protection Bureau, again, to their credit, Business Wire stepped up and changed its policies to stop selling direct subscriptions to high-frequency traders.

These are areas in which there's an open public debate. The SEC and the CFTC have raised questions in this area. To her credit, SEC Chairman Mary Jo White has tried to work out a system of circuit-breakers to prevent massive fluctuations from damaging the market. But there is a lot more work to do.

One of the most common threads that make most of these things we've been focused on so troubling is the increasing importance to our markets of this arms race among high-frequency traders, this desire to shave milliseconds of speed off and thereby gain a competitive advantage.

High-frequency trading did not even really exist 10 years ago, but in some respects it's coming to dominate our markets. And, unfortunately, our markets and market institutions have started to cater to these traders.

High-frequency trading involves fully automated trading using rapid movements in and out of securities – often for less than a second. Even if you only make a few cents on each transaction, if you move enough money in and out quickly, you can make billions of dollars per year.

Unlike the rest of us who invest in the markets, as I hope you all do, some high-frequency traders appear to trade with virtually no risk. This is something we're very interested in. Last week, a large high-frequency trading shop disclosed that it made money on every trading day over the course of four years. Out of 1,238 trading days, they made a profit on 1,237 of those days. I do not begrudge anyone their right to make money, but if something seems to be too good to be true, it usually is. Aand we question whether there are some traders that are just so smart that they never, ever lose money without some special advantage.

Ladies and gentlemen, let's keep in mind what we are talking about here. Our capital markets are supposed to work not in a system that guarantees profits for one segment or one set of traders. The purpose is to facilitate capital formation by putting investors together with companies so that investors can earn a fair return on their investment, and the companies they invest in can become stronger, helping our economy grow.

There's something very valuable and precious about our American capital markets, and we have to see that they are protected and perceived by the rest of the world as fair, as transparent and as not giving an edge to any one type of trader.

High-frequency trading –when it benefits from unfair advantages, and it can benefit from advantages, as I was saying, that others just can't do anything with, so it hasn't really been on the radar screen of regulators up until the emergence of high-frequency trading – it doesn't contribute to the goals of capital formation and long-term investment. These traders move in and out of a security faster in less than the blink of an eye.

It is up to those of us who regulate and who enforce the securities laws to deal with the fact that these traders are now benefiting from special, early access to information that can't be used the same way by the rest of the markets.

As Warren Buffett said, high-frequency trading "is not contributing anything to capitalism."

In fact, these high-speed automated trading systems also pose a very real danger to markets. In May 2010, a frenzy of trading led by high-frequency traders sent the market spiraling out of control -- and the term "flash crash" entered our lexicon.

Last April, a false Twitter report of explosions at the White House set off a wave of panic trading led by high-frequency traders, and the Dow lost 143 points in less than a minute, in spite of the fact that it was immediately – immediately, within a matter of less than a minute – revealed that this was a false report.

To her credit, again, the SEC has seen this problem, and they've gotten a circuit breaker installed to try and limit the effects of flash crashes, but in my view, the danger to market stability posed by high-frequency trading still requires a lot more work on our part.

The unfair advantages enjoyed by these traders have to be dealt with, again, with the view that there are things done that, 10 years ago, no one cared about. We really didn't care about certain types of information moving out a few seconds before for one group from another; now, we have to focus on that.

One of the worst problems we've discovered as we've looked at this over the last year is the tendency for our markets and institutions to start catering to high-frequency traders, and becoming enablers of this particularly dangerous type of trading.

High-frequency trading – there's always been this argument that it does provide increased liquidity, but it also provides increased instability – we have to find a way to maintain the liquidity while limiting, if not eliminating, the instability.

We see now new products and services that are going in the opposite direction. They are designed to uniquely benefit high-frequency traders -- the Thomson Reuters two-second edge was one example, but now the stock exchanges themselves are selling high-frequency trading firms direct access to their own data centers.

For a fee, you can get your computer, if you're a high-frequency trader, co-located within the exchanges' data centers. Your computer is right there, on the floor, where the rest of the data centers for the exchange are kept. Having your trading computer physically within an exchange's data center reduces the time it takes market information to transmit between the two by milliseconds. This makes all the difference to high-frequency traders, who are uniquely able to maximize the value of co-location.

In that tiny sliver of time, these firms get a first look at the direct-data feeds provided by the exchanges. They see pricing, volume, trade and order information and use it with their sophisticated technology, and algorithms that make the systems automatic, to trade on it before others can possibly react.

In fact, high-frequency traders look for arbitrage opportunities between and among the various exchanges. Any tiny time lag can make a huge difference. They move on price and order information before the rest of the market really sees it or is able to digest it -- all in order to capture momentary differences in stock prices.

These are not really investing strategies. Most of these traders start with nothing, with no portfolio, and they end the day with no portfolio. But they move in and out of the market thousands and thousands of times.

Co-location arrangements, which is a particular focus of our office right now, also allow high-frequency trading firms to continuously monitor all the exchanges for large incoming orders. And if they spot a large order from an institutional investor, like a pension fund, high-frequency traders can instantaneously get on the other side of the trade -- driving up the prices artificially.

This has forced many large, institutional investors to develop complicated and expensive defensive strategies in order to conceal their legitimate orders. Some try to route their orders into alternative trading venues, and these alternative venues are even less regulated, have fewer reporting requirements and are far less transparent. That includes the so-called dark pools.

Even though co-location is nominally available to everyone, you or I could not possibly take advantage of it. And it even if we could, none of us are looking to move in and out of stock positions in milliseconds, like high-frequency traders. Most of us try to invest for something like a long-term effort to build value in a company.

We know that high-frequency traders are uniquely able to take advantage of co-location, but there are other services also offered by the exchanges to make it easier for them to take advantage of this very, very slight edge.

They supply extra bandwidth, special high-speed switches and ultra-fast connection cables to high-frequency traders, so they can get, and receive, information at the exchanges' data centers even faster. These valuable advantages, once again, give them a leg up on the rest of the market.

Our panel of experts is going to discuss this, I'm sure. But we really have to think about what is the benefit we get from this new trend in our markets. They benefit themselves, clearly, by making billions of dollars per year, and the exchanges make money on the specialized services and co-location they sell to high-frequency traders. But this happens at the expense of the rest of the investing public who truly contribute to our capital markets.

So my office is going to continue to shine a light on unseemly practices in the markets in this area, and in others, that cater to high-frequency traders at the expense of other investors. This is going to include critically examining the strategies used by HFTs against the rest of the investing public, and the benefits they get out of services offered to them by the exchanges and other players.

I look forward to joining with other regulators, with my colleagues in government, to take real, concrete steps to deal with this problem. We have had some inquiries and ideas floated by the SEC and the CFTC, but it's time for us all collectively to step up to this challenge.

We have to review, and it's something I want to raise, and I'm sure it will be discussed at the panel, and carefully consider a proposal that I like very much. It was put forward by economists at the University of Chicago School of Business – not an enemy of free markets, the University of Chicago School of Business, by any means.

In December, they issued a detailed and thoughtful proposal for reforms that would fundamentally reorient the markets in a very simple way that would help restore confidence in them. Their proposals would reaffirm the basic concept that the best price -- not the highest speed -- should win.

Currently, on our exchanges, securities are traded continuously, which means that orders are constantly accepted and matched with ties broken based on which orders arrived first. This system rewards high-frequency traders who continuously flood the market with orders – emphasizing speed over price.

The University of Chicago proposal – which I endorse – would, in effect, put a speed bump in place. Orders would be processed in batches after short intervals – potentially a second or less than a second in length – but that would ensure that the price would be the deciding factor in who obtains a trade, not who has the fastest supercomputer and early access to market-moving information.

This structural reform – sometimes called "frequent batch auctions" -- would help catch and cap the supercomputer arms race now underway. This is tremendously important, because even advocates of high-frequency trading have always recognized that the potential for destabilization of the markets from volatility is a problem.

If you had frequent batch auctions, there's no point in trying to get faster than whatever the interval is. It would discourage the risk taking that can cause flash crashes because, in the quest for greater and greater speed, there is, in and of itself, a threat to market stability. It rewards those who are taking chances. It rewards those who try risky new ways to gain a few milliseconds of speed. And that's something we could put an end to if this proposal were successfully carried out.

Market reforms -- such as the frequent batch auction proposal -- would limit the incentive to rush to use untested, potentially destabilizing speed enhancements and could actually increase liquidity by reducing the costs imposed on all market participants.

Now, as I said at the outset, our markets have gone through significant changes in recent years. On balance, technology has been very good for the markets. But the current system, and the culture that has developed around the current system of high-frequency trading, is really in need of reform. The good news is that there are essentially simple ways to eliminate some of the fundamental unfairness and dangers in our market and to strengthen our capital markets even further.

Building tremendously lucrative advantages into markets for high-frequency traders at the expense of the investing public is wrong. The idea of the United States, and this permeates all 30 bureaus in my office, is that no one's supposed to have a special advantage. We're supposed to be a little more equal than the rest of the world. That's why we didn't have kings or aristocrats, and the idea was to have something close to a level playing field. And each generation strives to maintain that level of equality, which we never perfectly attain, but in some respects that is our mission.

The United States of America is not just a country, it's a project. And in New York, for many, many years, certainly throughout much of the last century, we led the way in innovation to try and realize these ideals of giving everyone an opportunity – not guaranteeing success, but seeing to it that everyone has a fair shot.

There are a lot of investors that are not getting back into the markets because they are afraid of this technology and they have the sense that the smaller investors will never get a fair shot. That's something that we have to work on collectively, and that's something that my office is committed to.

Everyone – individuals and giant corporations – should be able to use their brains and their guts, their insights, their efforts to succeed. And it's time that we focus on structural reforms – and restoring the mindset of winning based on price, winning based on smarts, rather than winning based on speed and even trickier technology with your new supercomputer – that's something we have to do to eliminate the unfair advantages and the dangers posed by high-frequency trading.

I hope that fair-minded market participants will support me in this effort, and I hope that you will join me in urging other law enforcement officials and regulators to deal with these problems. They are new problems, and everyone's overextended, budgets are limited, but I would urge you, this is something that cries out for our regulators and our law enforcement agencies to address in the very, very immediate future.

Thank you, and I hope that you will join me in this effort as well.