Insider Trading and Market Structure

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Main propositions of the paper

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1. HFT trading creates information asymmetries between HFT traders and others.
2. Conventional insider trading doctrine does not address these information asymmetries. (Structural insiders v. conventional insiders)
3. Conventional insider trading doctrine must be re-visited to address information asymmetries arising from HFT trading.

Story explained

1. HFT traders use co-located servers, rich data feeds and are able to respond faster to trade-related data.
2. By placing orders ahead of the others, they stand between an informed trader and the best available price on the market.

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1. HFT traders use co-located servers, rich data feeds and are able to respond faster to trade-related data.
2. By placing orders ahead of the others, they stand between an informed trader and the best available price on the market.
3. Apprehensions:
   Increased cost of trading • Capital flight • Cloak and dagger behaviour.

Insider trading v. HFT trading

- Insider trading doctrine involves an element of deceit:
  - *Classical theory*: Breach of fiduciary obligation to other shareholders.
  - *Misappropriation theory*: Breach of obligation to a source of information.
- Rule 10b-5, Section 10b of the *Securities Exchange Act, 1934* envisage manipulation, deceipt and fraud.
- These elements are absent (though not necessarily!) when a HFT trader responds to trade-related data.

Information asymmetries

- Only commonality between an insider and a HFT trader is, therefore, information asymmetry.
- Not all information asymmetry warrants intervention (*Hall, 2007*).
- Treatment of previous technological innovations which have caused information asymmetries. Examples:
  1. Transition from pit-trading to electronic trading
  2. Transition in retail trading from phone to electronic trading
  3. In Indian context, transition from 3G to 4G!

Some areas worth exploring

- Popular discourse categorizes “all” HFT trading as market abuse. Problems:
  1. Presumption of guilt in all HFT trading.
     - Example: Most common allegation against a HFT is “front running” other investors. In an anonymised trading system, front-running may just be an educated guess of what’s coming up.
  2. What happens when one HFT trader is trading with another HFT trader?
- If policy frowns upon co-location, it throws open the debate on information asymmetries arising from proximity issues. How close is TOO close??
- Will introducing latencies destroy the efficiencies that HFT trading brings to the market? Should this be a private sector solution?

Some areas worth exploring (contd.)

1. Can HFT trading fit within the overall regulatory framework for market abuse?
2. Easier surveillance - Does HFT trading make datamining easier for the regulator?
3. Regulatory capacity

Thank you