Pragma Research Recommends Market Structure Changes to Reduce Trading Costs for Investors

NEW YORK – July 27, 2012 – Pragma Securities, an independent algorithmic trading boutique, today announced recommendations for market structure changes, which would reduce the amount investors lose in trading costs. The recommendations are based on recent Pragma research showing that when High Frequency Trading (HFT) market makers compete with directional traders, i.e., investors, to earn spreads and rebates by providing liquidity, investors are forced to cross the spread more often, which results in higher costs.

Many ultra-high-volume stocks have disproportionally long order queues—a result of the huge number of HFT orders competing to provide liquidity compared with the rate at which aggressive orders arrive to take that liquidity. The effect is most problematic in low-price, low-volatility stocks. In these instances, the excessive competition makes it harder for directional traders to successfully provide liquidity. Instead, they must cross the spread more frequently, increasing their overall trading costs. One solution, according to Pragma's research, is to reduce the tick size in low-priced stocks to $0.001, resulting in narrower effective spreads, reduced profits drawn out to market makers and providing a net savings for investors.

David Mechner, CEO of Pragma, notes that while market-making is an important function in the smooth operation of markets, the penny tick size—when combined with the current maker/taker system of exchange fees and rebates—distorts the market and effectively forces investors to subsidize the activity of HFTs. "Our research presents strong evidence that market makers' liquidity does not come for free, and a reduction of tick size and rebates for providing liquidity will provide directional traders with more control over their trading costs," commented Mechner.

With HFT accounting for upwards of 50 percent of market volume according to some estimates, regulatory focus on the practice has increased considerably, particularly following the so called "flash-crash" of May 2010. However, while prevailing industry sentiment on HFT is negative, the consensus academic view remains that HFT market makers provide a valuable service to the market through the liquidity they provide. However, as Pragma notes in its research paper, there is an inherent paradox in HFTs simultaneously creating better trading opportunities for directional traders while pulling $5 billion annually out of the market in trading profits, according to estimates from the TABB Group.

Pragma's observations, built on the latest in its ongoing series of research notes, sheds light on the impact HFT market makers have on trading costs as a result of the current regulatory environment, and, further, provides concrete recommendations that would allow counterparties to interact at a more natural equilibrium.

"Our clients depend on us to provide novel insights into trading and what drives trading performance, including aspects of market structure." explained Eran Fishler, COO and Director of Research at Pragma. "Technology is constantly changing how investors interact with the market, and as an independent provider of trading tools, our clients look to us for unbiased, empirically grounded information."

To access Pragma's research, please visit www.pragmatrading.com.

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About Pragma Securities
Pragma Securities is an independent electronic trading boutique specializing in broker-independent algorithmic trading tools and analytical services for a wide range of market participants including institutions, hedge funds, brokers, and exchanges. For more information, please visit www.pragmatrading.com

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