FINRA is the non-profit entity that has been authorized by the SEC, the Securities & Exchange Commission, to regulate the securities industry. FINRA stands for Financial Industry Regulatory Authority. (This job used to be done by the NASD, National Association of Securities Dealers, until their baby, the NASDAQ, got so big that they abandoned their regulatory responsibilities and devoted themselves full time to the NASDAQ.) In the presentation, we discussed the emergence of high-frequency trading. To be truthful, Dear Students, I am almost as in the dark about these activities as all of you. To my mind, there does not seem to be any viable economic reason for allowing entities to initiate millions of trades each day. You or I could never do anything like this because our transaction costs would be enormous. These companies are obviously able to trade for far less than a penny per trade or some simple arithmetic would tell you that they would be spending tens of thousands of dollars every day just in trading costs. More importantly, when the general public hears about these types of tricks and shenanigans, it only serves to confirm many of the common stereotypes of the folks on Wall Street being nothing more than crooks and charlatans. The following is an excerpt from FINRA's 2012 Annual Regulatory & Examination Priorities Report. It discusses the phenomenon of high-frequency trading and what they will be watching for. As far as I can figure out, they are watching for three things. They want to prohibit high-frequency trades that are simply done to bait other high-frequency trades. (Uh, what other reasons would there be for high-frequency trading?) They want to make sure that the firms involved are evaluating the high-frequency trading. (Kinda' like having the foxes guard the chicken coop, right?) And they are worried about evil-doers from foreign lands doing bad things. (As if it matters who is doing the bad things?)

High Frequency Trading

While most high frequency trading (HFT) strategies are legitimate and can serve to provide liquidity and pricing efficiency, others can be used for manipulative purposes. In addition, even when there may not be a manipulative intent behind the trading, the velocity of HFT can result in unintended consequences in terms of quote generation and other activities. As a result, the surveillance of HFT remains a high priority for FINRA and requires firms using HFT strategies and other trading algorithms to be vigilant when testing these strategies pre- and post-launch to ensure that the strategies do not result in abusive trading and/or unintended consequences. Following are more specific areas of concern that FINRA will continue to pursue.

- FINRA continues to be concerned about the use of so-called "momentum ignition strategies," where a market participant attempts to induce others to trade at artificially high or low prices. Examples of this activity include layering strategies where a market participant places a bona fide order on one side of the market and simultaneously "layers" non-bona fide orders on the other side of the market (typically above the offer or below the bid) in an attempt to bait other market participants to react to the non-bona fide orders and trade with the bona fide order on the other side of the market. FINRA has observed several variations of this strategy in terms of the number, price and size of the non-bona fide orders, but the essential purpose behind these orders remains the same, to bait others to trade at higher or lower prices. FINRA also has seen wash sales used in conjunction with layering to give the appearance of bona fide transactions at artificial prices. Other examples of problematic HFT or algorithmic activity include momentum ignition and spoofing strategies related to the open or close of regular market hours that involve distorting disseminated market imbalance indicators through the entry of non-bona fide orders and/or aggressive trading activity near the open or close. FINRA also is concerned with abusive cross-product HFT strategies and other algorithms where stock transactions are effected to impact options prices and vice versa. FINRA will continue to aggressively pursue these types of problematic HFT strategies and algorithms.

- Consistent with the Market Access Rule and other supervisory obligations, FINRA will assess whether firms have adequate testing and controls related to HFT and other algorithmic trading strategies. FINRA's evaluation of firms' controls may take the form of examinations and targeted investigations. Potential areas of review will include, among other things, the development, testing, deployment and maintenance of algorithmic codes; the adequacy of controls and followup regarding message rates; and procedures and controls to detect potential trading abuses such as, without limitation, wash sales and momentum ignition strategies.

- FINRA also will continue to focus on the entry of problematic HFT and algorithmic activity through sponsored participants who initiate their activity from outside of the United States. In this regard, member firms are reminded of their surveillance and control obligations under the Market Access Rule and Notice to Members 04-66, as well as potential issues related to treating such accounts as customer accounts, anti-money laundering and margin levels, as highlighted in Regulatory Notice 10-18 and the SEC's Office of Compliance Inspections and Examination's National Exam Risk Alert dated September 29, 2011. FINRA will continue to devote substantial resources to the examination, detection, surveillance and prosecution of such conduct.