"Breaking Bad"

Jesse: And why'd you go and tell her I was selling you weed?

Walt: Because somehow it seemed preferable to admitting that I cook crystal meth and killed a man.

— "Breaking Bad" (2008)

Meadow: Are you in the Mafia?

Tony: Am I in the what?

Meadow: Whatever you want to call it. Organized crime.

Tony: Who told you that?

Meadow: Dad, I've lived in the house all my life. I've seen the police come with warrants. I've seen you going out at three in the morning.

Tony: So you never seen Doc Cusamano going out at three in the morning on a call?

Meadow: Did the Cusamano kids ever find $50,000 in Krugerrands and a .45 automatic while they were hunting for Easter eggs?

Tony: I'm in the waste management business. Everybody immediately assumes you're mobbed up. It's a stereotype. And it's offensive. And you're the last person I would want to perpetuate it. There is no Mafia.

Meadow: Fine.

Tony: [pause] Alright … look, Mead, you're a grown woman, almost. Some of my money … comes from illegal gambling and whatnot. How does that make you feel?

Meadow: At least you don't keep denying it, like Mom.

— "The Sopranos" (1999)

Jane: You're lying! Now I know why Ed's been calling every half hour. You've been back on the case, haven't you?

Frank: No! I swear it's another woman!

— "Naked Gun 33 1/3: The Final Insult" (1994)

Always confess to a small crime if you want to hide the big stuff. I remember reading this in a Robert Heinlein sci-fi novel when I was a kid, and it's stuck with me ever since. Once you start looking for this trope you see it everywhere, and even if it goes a little over the top at times in scripted media (anyone remember the "24" season where Jack Bauer tortures *his own brother*, who gives up a partial truth to hide their father's role as an arch-villain of treason?), I'm always on the look-out for it in the Narrative construction of our unscripted investment news media.

The problem in mass Narrative construction is not (or at least is very rarely) an issue of intentional misdirection through selective confession. But you don't need intentionality for this dynamic to take root and misdirect all the same. **Much more commonly, it's the spreading of an easy to understand revelation of old fashioned greed that generates such a sense of outrage among all of us that regulators and policy makers mobilize to "crack down" on a few obvious bad guys while leaving the underlying flawed system intact.** The result is that the flawed system often gets a new lease on life, as both the popular and regulatory attitude becomes "Oh … well, I guess so long as you're not doing THAT, then I suppose we've got nothing to worry about."

Case in point: the record $20 million fine levied by the SEC last week on ITG for its egregious wrongdoing in management of its trading dark pool. I can say that this was egregious wrongdoing without any fear of contradiction because – in sharp contrast to almost every settlement you've ever seen with the SEC, where the defendant "neither admits nor denies" anything – ITG was forced to confess as part of the settlement. You can read the SEC press release here, you can read the Bloomberg take here, and you can read the Wall Street Journal take here and here. As with most things market structure-related, I've learned a ton about this case from Sal Arnuk and Joe Saluzzi at Themis Trading, who put out a daily note on market structure that I think is very useful.

What did ITG do? They blatantly traded against the interests of their own clients, by peeking into their order book to buy and sell stock in other venues for their own account a few milliseconds ahead of their client orders. It's pretty much a textbook case of front running, only in a modern context of dark pools and multiple electronic trading venues. This predatory HFT program traded 1.3 billion shares and (per Arnuk and Saluzzi's calculations) impacted the pricing and execution of about 130 billion shares by a few pennies per share. That's billion with a B. My favorite factoid from the SEC docs: ITG ranked their clients by how easy they were to trade against, and – surprise! – tried to do more business with the suckers. Oh, and here's another shocker – the suckers were always the sell-side; ITG would turn off the program when it faced its buy-side clients. To be clear, this wasn't a "rogue" operation at ITG, but something that was explicitly approved by their Board ... twice.

My concern is NOT that what ITG did is rampant in the trading world. I doubt that any other dark pool operator or independent execution trader is cheating their clients in such an overt, really almost caricaturish fashion. My concern is in the grey area between cheating and edge. My concern is that our market structure is fundamentally flawed – or at least contains unanticipated and uncompensated risks – and that an honest discussion of those flaws will be shunted to the side in favor of easy regulatory posturing against those darn evil-doers. My strong hunch is that a regulatory and media focus on obvious front running will lock in the current market structure, although equally bad for investors would be some sort of witch hunt against all dark pools and all electronic trading venues.

Whichever way it goes, though, the ultimate result will be the same – **an accelerated victory of the big bank trading groups over the high-tech trading firms for control of market flow data.** HFT liquidity providers and quant-oriented execution shops are technology companies disguised as financial intermediaries. They hijacked the market infrastructure in the aftermath of the Great Recession, stealing it away from under the noses of the big financial firms who had come to see control over market structure as their birthright, and they had a good run. But now the big boys want their market infrastructure back, and they're going to get it.

A lot of HFT critics are crowing over the ITG confession. You see! HFT is front running, plain and simple! Told you! And HFT defenders are largely silent because … well, you can't defend the indefensible. I'm in the anti-HFT camp (see "The Adaptive Genius of Rigged Markets"), but I'm not crowing. If history is any guide at all, the existence of a clearly identifiable small-v villain will forestall the unmasking of what I believe is a Big Bad … the subterranean influence, bordering on control, of human investment behaviors by firms controlling advanced inference machines (see "Troy Will Burn – the Big Deal about Big Data"). Market infrastructure is only the first battleground in this war, but it's a critical one. If even more advanced non-human intelligences owned by even more powerful institutions are allowed even more unmonitored and unregulated access to even more massive order books, this first battle is even more lost than it already is. But that's exactly where I think we're headed.

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