

Leveraging computer science methods to represent and design market models

Dragiša Žunić @ GSSI

&

Emilio Tuosto @ GSSI

Joint work with

Linda Brodo @ Sassari

Roberto Bruni @ Pisa

Ayman Hussein @ DTU

Joint Seminar Series
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Today's menu

- ▶ Market model design is tricky
 - ▶ CLOB issues
 - ▶ FBA solution
 - ▶ FBA issues

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 - ▶ A new **concurrent** model
 - ▶ **concurrency**: what can be executed independently?

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 - ▶ **parallelism**: what can be executed at the same time?

The latter requires the former, not viceversa!
 - ▶ A formal definition of **CX** ... with a lot of hand-weaving 😊
 - ▶ Supported by a prototype tool for simulations

Take-away message

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- ▶ can certify desirable properties (or show absence of undesirable ones)

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- ▶ is more “natural” than CLOB (& FBA)
- ▶ is white-box: rules precisely defined **and applied**
- ▶ can certify desirable properties (or show absence of undesirable ones)

There is a prototype ... which can also be shown to be correct

Is our approach worthwhile?

Is our approach worthwhile?

JEL Codes: D47, G10, G12, G14

“The market is rigged.” —Michael Lewis, *Flash Boys* (Lewis 2014)

“Widespread latency arbitrage is a myth.” —Bill Harts, CEO of the Modern Markets Initiative, a high-frequency trading (HFT) lobbyist (Michaels 2016)



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JOURNAL ARTICLE
Quantifying the High-Frequency Trading
“Arms Race”
Matteo Aquilina, Eric Budish, Peter O’Neill

Volume 137, Issue 1
February 2022

Article Contents

The Quarterly Journal of Economics, Volume
137, Issue 1, February 2022, Pages 493–564,
<https://doi.org/10.1093/qje/qjab032>
Published: 10 September 2021

– Market models –

Trading floor and open outcry



CBOT "The Pit" in 1908



The New York stock exchange trading floor in September 1963, before the introduction of electronic readouts and computer screens



Open outcry "pit" at the Chicago Board of Trade (CBOT) in 1993

- ▶ Human-mediated market interaction (open outcry)
- ▶ ... humans performed order-matching and agreed on trades

Towards electronic systems

- ▶ 1971: NASDAQ introduced elements of electronic infrastructure
- ▶ 1977: Toronto Stock Exchange
 - ▶ First operational electronic limit order book system in the world
 - ▶ Initially used only for less liquid stocks, not the entire main market
- ▶ 1986: Paris Bourse: starts using CLOB as primary mechanism
- ▶ 1990s–2000s: NYSE, NASDAQ, and CME transitioned to electronic matching
- ▶ Today: market matching is automated, but fundamentally sequential (CLOB)

1992–1994: Borsa Italiana completed the transition from open outcry to electronic trading (<https://www.borsaitaliana.it/borsaitaliana/storia/storia/telematizzazione-scambi.en.htm>)



The big question



CME trading pits, Chicago (2025)



Open outcry, Japan (circa 1960)

- ▶ *What is the real nature of the “computation” taking place on a trading venue?*

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- ▶ Concurrency / Parallelism?
- ▶ What is the “right” model?

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- ▶ *What is the real nature of the “computation” taking place on a trading venue?*
- ▶ Concurrency / Parallelism?
- ▶ What is the “right” model?
- ▶ We must start from a blank paper

Overview: where are we?

- ▶ **Fundamental** market design
- ▶ When humans were removed, markets converged to the CLOB model
- ▶ Is that solution optimal?
- ▶ *Is it optimally designed as a computational model at the fundamental level?*
- ▶ Not quite ...

Overview: where are we?

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- ▶ Motivation for Frequent Batch Auctions (Budish et al, 2015.)



Volume 130, Issue 4
November 2015

JOURNAL ARTICLE EDITOR'S CHOICE

The High-Frequency Trading Arms Race: Frequent Batch Auctions as a Market Design Response *

Eric Budish, Peter Cramton, John Shim

The Quarterly Journal of Economics, Volume 130, Issue 4, November 2015, Pages 1547–1621, <https://doi.org/10.1093/qje/qjv027>

Published: 23 July 2015

The issue with CLOB

The problem arises from the **interaction** of two **fundamental** design choices:

1. Treating time as continuous
2. Sequential processing of orders

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The problem arises from the **interaction** of two **fundamental** design choices:

1. Treating time as continuous
2. Sequential processing of orders

Both at the level of fundamental design

Manifest later at different levels

FBA's solution

Key idea: address both in the following way:

1. "Put time into discrete units"
(discretize time into small uniform intervals)
2. "Process incoming orders in *batches* using auctions"
(match orders simultaneously at the end of each interval; single market clearing price)

Frequent Batch Auctions

Budish, Cramton, Shim. *The high-frequency trading arms race: frequent batch auctions as a market design response*. QJE, 2015.

Limitation of FBA

Remark: FBAs work aimed to reveal the structural issues of markets, rather than a quest for definitive computational model(s).

FBA removes continuous-time priority ✓

However, regarding order matching: ❓

- ▶ Concurrency is not explicit in the model
- ▶ Parallelism is not native to the computation

Moreover, at the structural level: ❓

- ▶ Incoming orders are not mandated to always interact first with the resident market¹

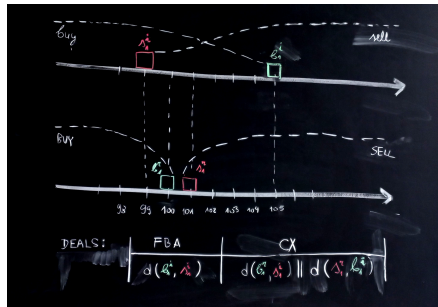
¹In CLOB, incoming orders always interact with the resident market first. By necessity.

Our solution **CX**: beyond FBA

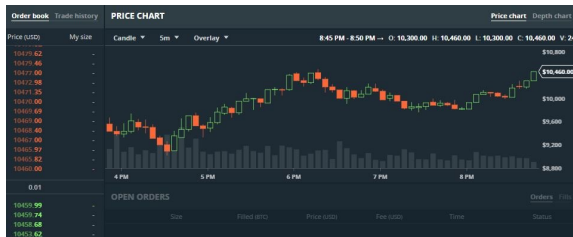
1. Put time into discrete units ✓ (as in FBA)
 2. Enable natural concurrency and parallelism in order matching ✓✓ (while preserving desirable computational and economic properties)
- ▶ Incoming order flow is mandated to always interact first with the resident market ✓

CX:

- ▶ enabling native concurrency and parallelism in electronic markets' computation
- ▶ retaining the structural consistency with CLOB, rather than departing from it



Clarification: main views of the market



Price chart (more often used)

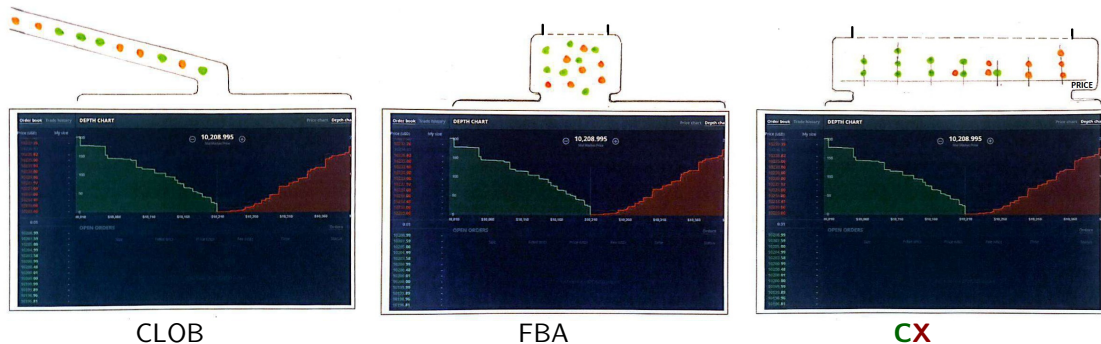


Depth chart (more holistic view)

From CLOB to FBA to CX

Key **starting insight** that **did not exist** and had to be recognized:

- ▶ incoming set of orders is a **market in its own right**², and therefore
- ▶ incoming and resident are two interacting markets



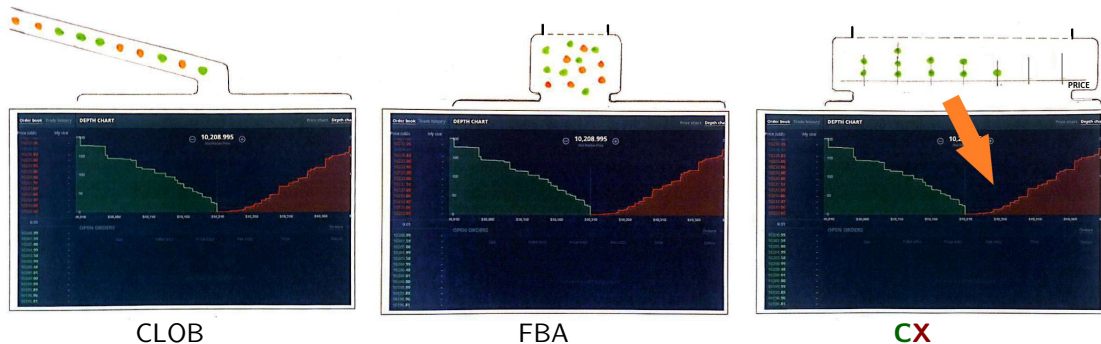
From **sequential**, to **batch**, to **parallel and concurrent processing**

²Pseudomarket, to be more precise.

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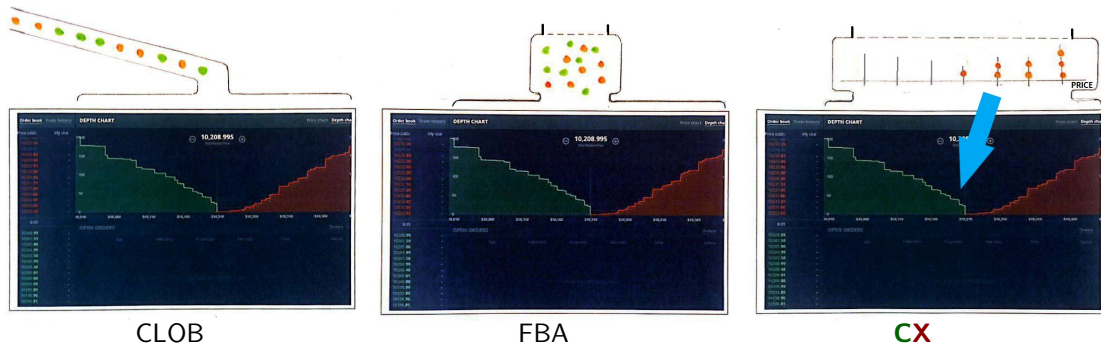
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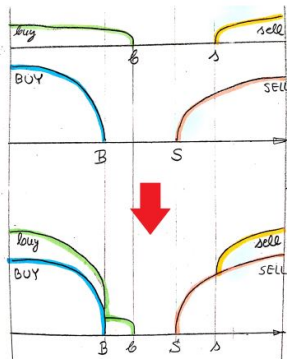
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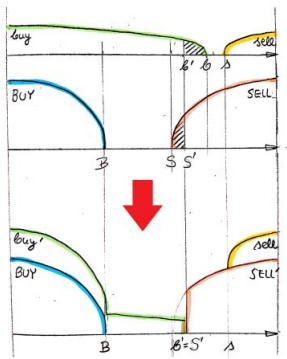
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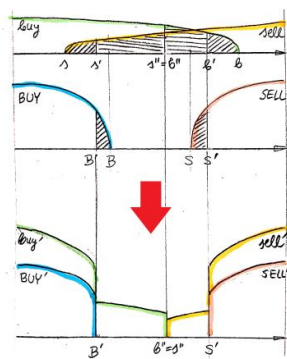
A closer look into **CX** computation



no successful order-matching

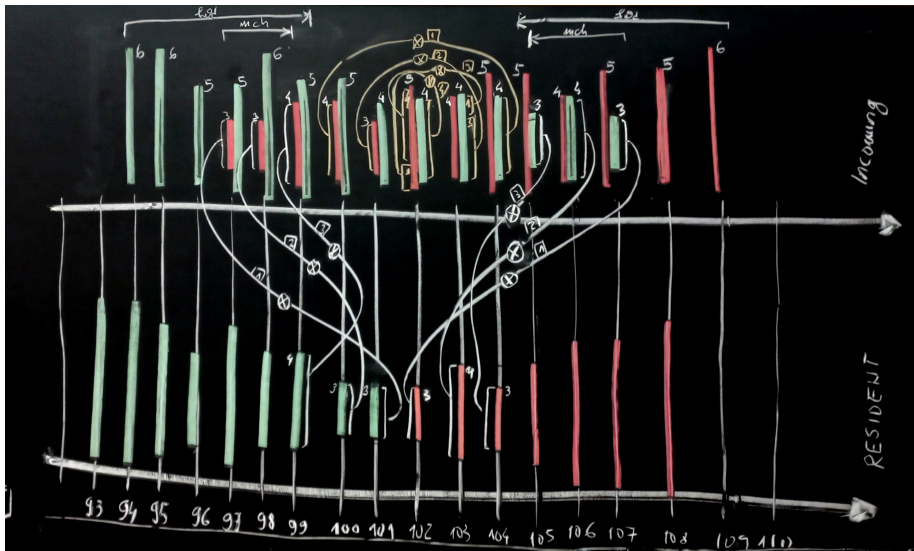


matching on one side



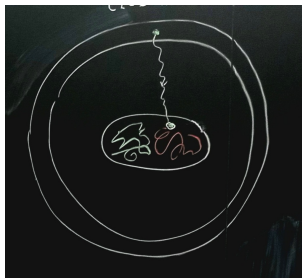
matching in all 3 segments

Illustrating an example computation



Another view on the 3 market models

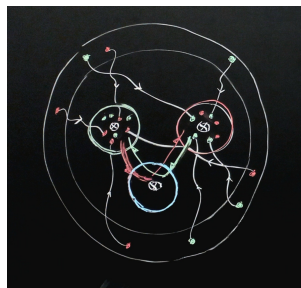
A higher level of abstraction: we emphasize the flow of orders, bringing the model closer to the **Reaction Systems** view of interaction.



CLOB

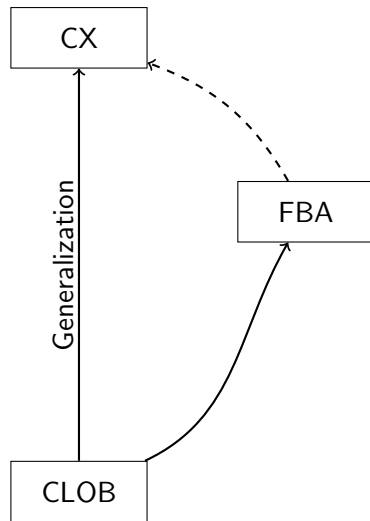


FBA



CX

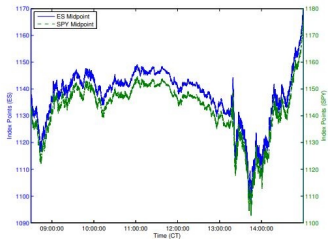
The big picture



The HFT issue: latency arbitrage in correlated assets, an example

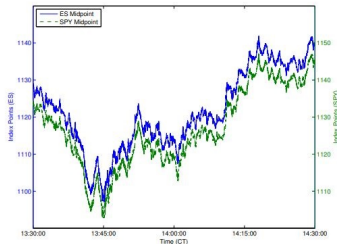
Market Correlations Break Down at High Frequency

ES vs. SPY: 1 Day



Market Correlations Break Down at High Frequency

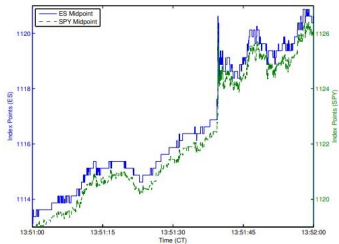
ES vs. SPY: 1 hour



Primarily related to speed; rooted in continuous time

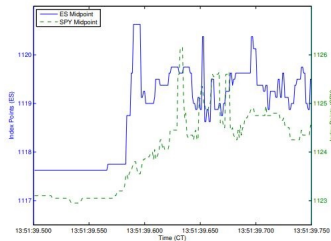
Market Correlations Break Down at High Frequency

ES vs. SPY: 1 minute



Market Correlations Break Down at High Frequency

ES vs. SPY: 250 milliseconds

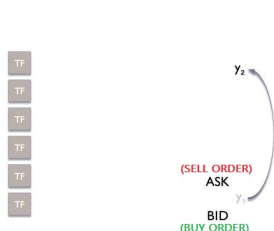


The sniping issue (related to front-running)

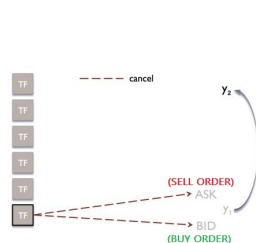
"Sniping"



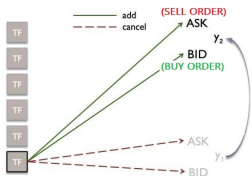
Fundamental value and bid-ask spread



Fundamental value jumps



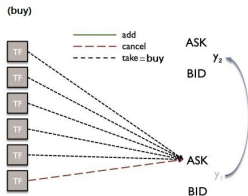
TFs providing liquidity send messages to cancel old quotes and add new quotes



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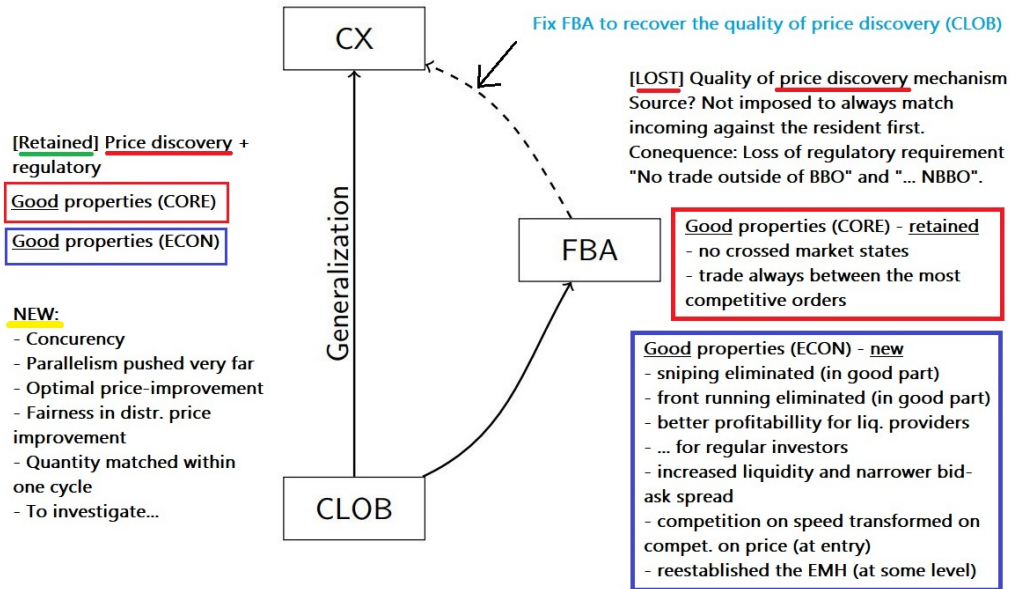
At same time, other TFs send messages to "snipe" the stale quotes



Because the market design processes messages in *serial*, liquidity providers get sniped with probability $\frac{N-1}{N} \dots$ even though the information was public and all TFs have the exact same technology

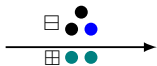
- ▶ Even assuming the same speed; primarily rooted in sequential order processing.

The big picture: properties

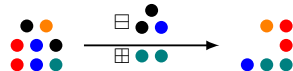
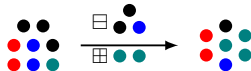
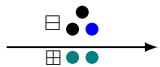


– A CS approach –

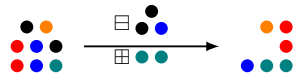
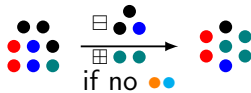
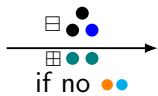
Reaction systems in a nutshell



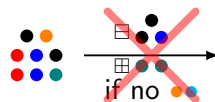
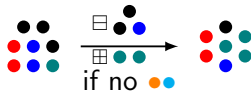
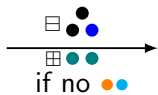
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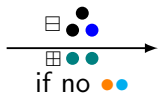
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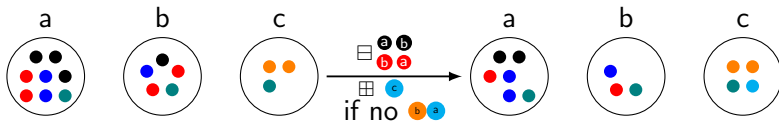
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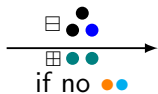
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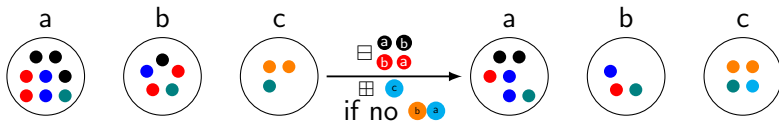
Locations:



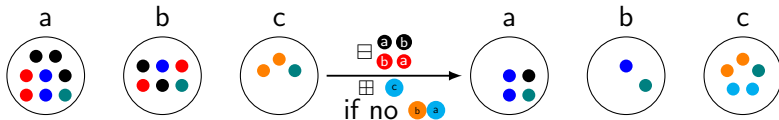
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Locations:



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Formalising markets' with reaction systems



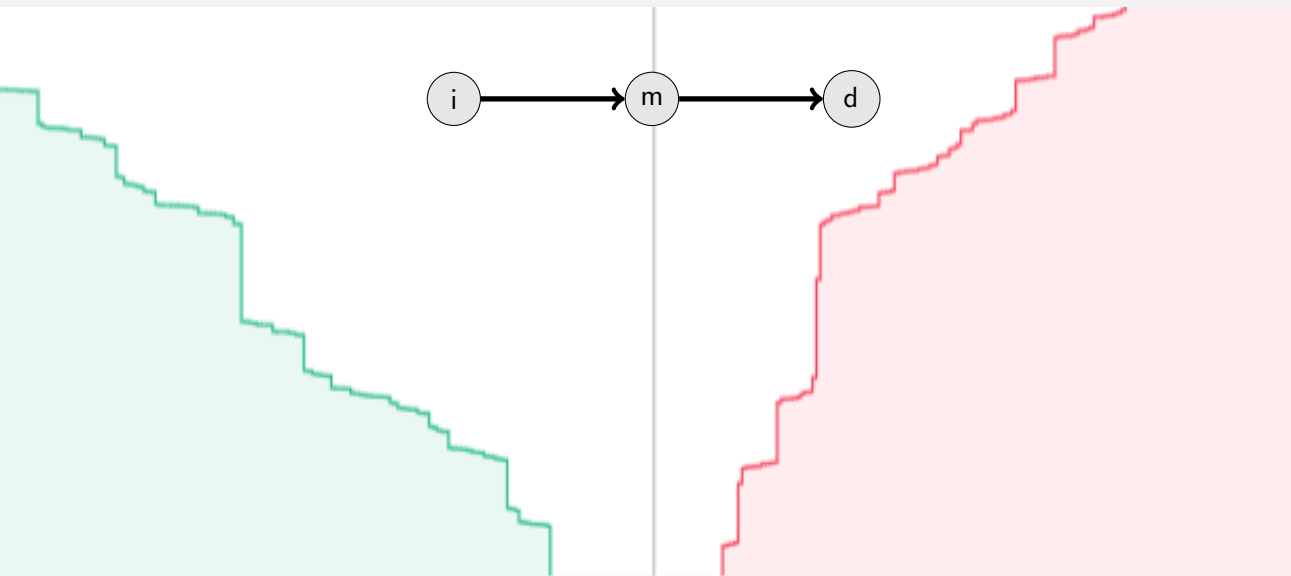
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Formalising markets' with reaction systems



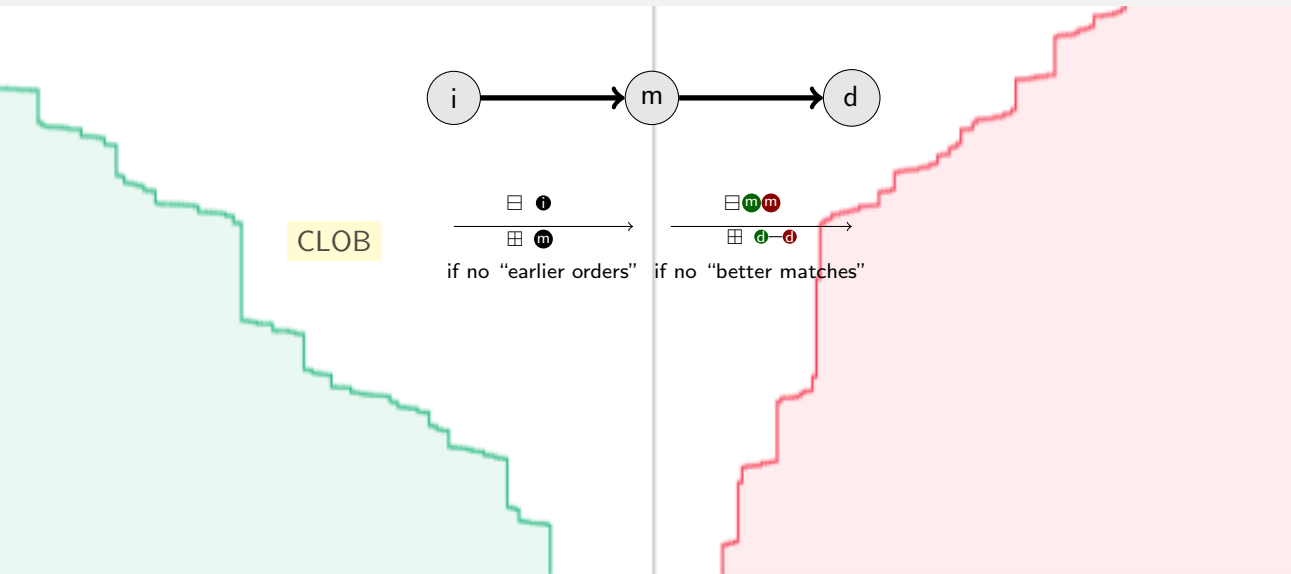
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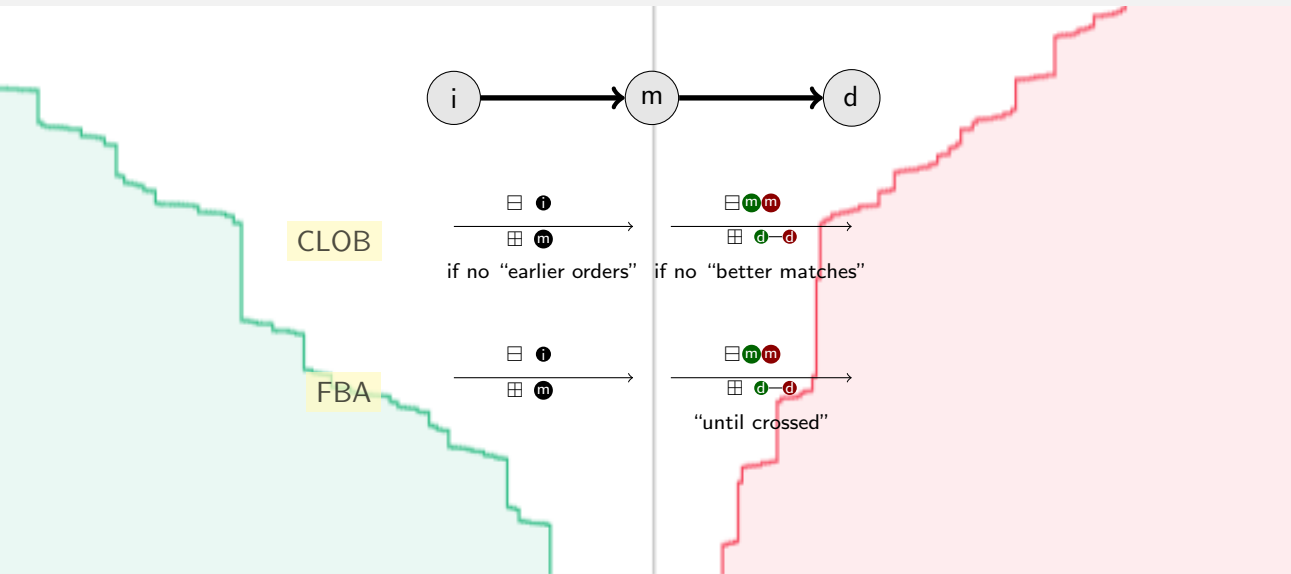


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Formalising markets' with reaction systems



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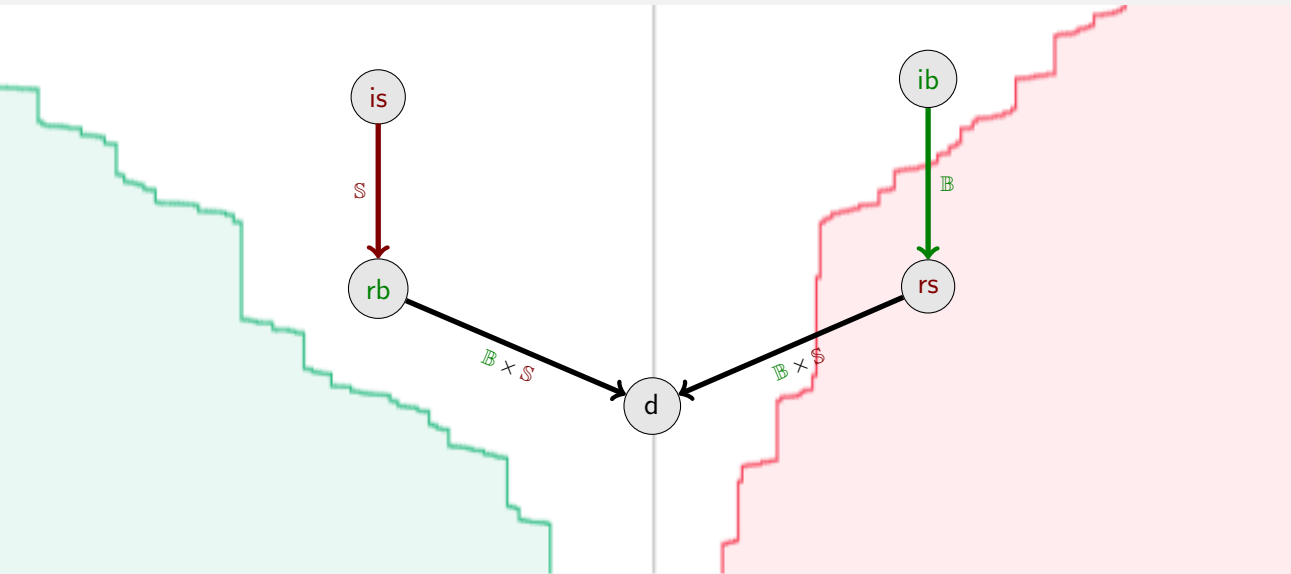
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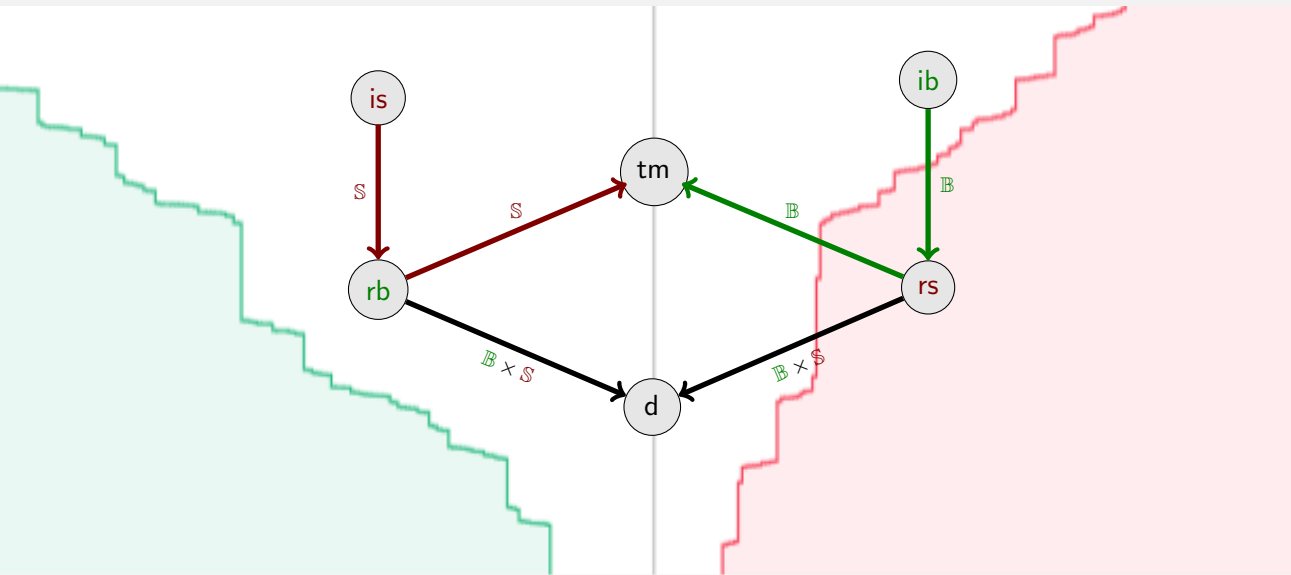
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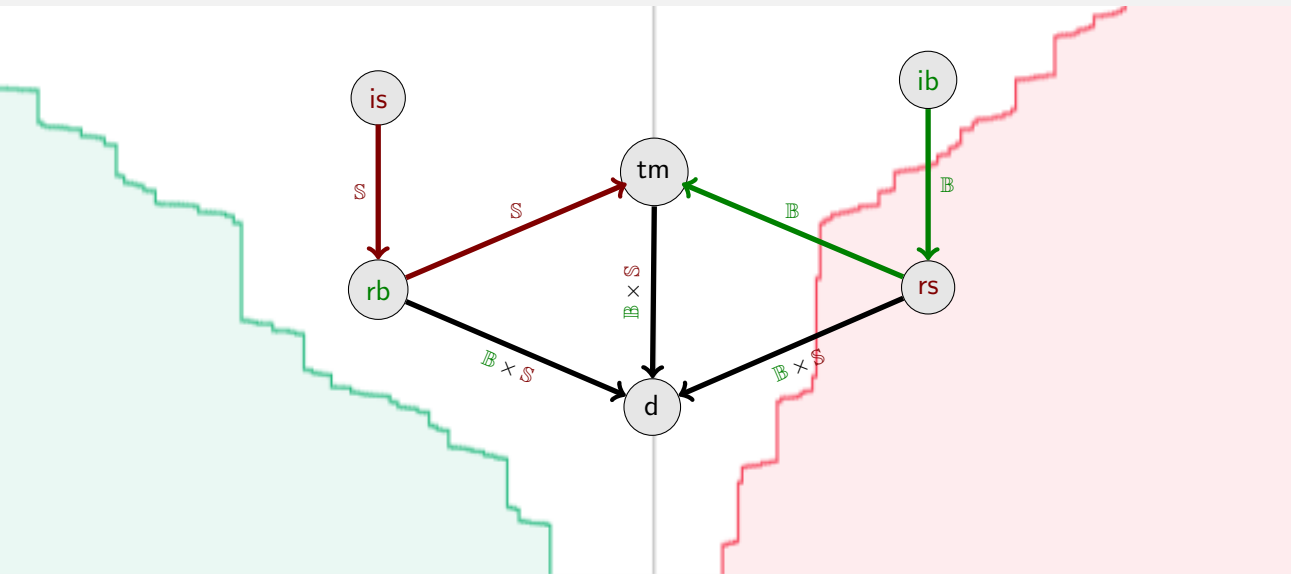
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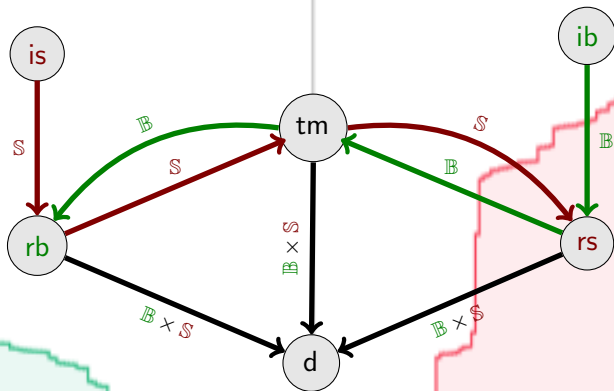
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CX: A new market model



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A glimpse of **CX**'s formalisation

$$r_{\text{deal}} = \ell[(\text{tok}(\ell), \mathbf{b}^{\otimes i}, \mathbf{s}^{\otimes j} ; \mathbb{B}^{>i} \cup \mathbb{S}^{<j} ; \text{tok}(\ell), d_{(\mathbf{b}^{\otimes i}, \mathbf{s}^{\otimes j})})]$$

$$r_{\text{fwd}} = \ell[(\text{tok}(\ell), e ; \bar{e} ; \text{tok}(\ell), \ell'[e])]$$

$$r_{\text{ctl}} = \ell[(\text{tok}(\ell) ; I ; \ell'[\text{tok}(\ell')])] \quad \text{with} \quad \ell \neq \text{tm} \text{ and } \ell \xrightarrow{I} \ell' \text{ in } \mathcal{G}$$

$$r_{\text{tms}} = \text{tm}_{(\beta, \sigma ; \emptyset ; \tau)}$$

$$r_{\text{close}} = \text{tm}_{(\tau ; \mathbb{B} \cup \mathbb{S} ; \text{ib}[\beta], \text{is}[\sigma])}$$

Added values

We can prove several properties:

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- ▶ No trade outside current bid or ask
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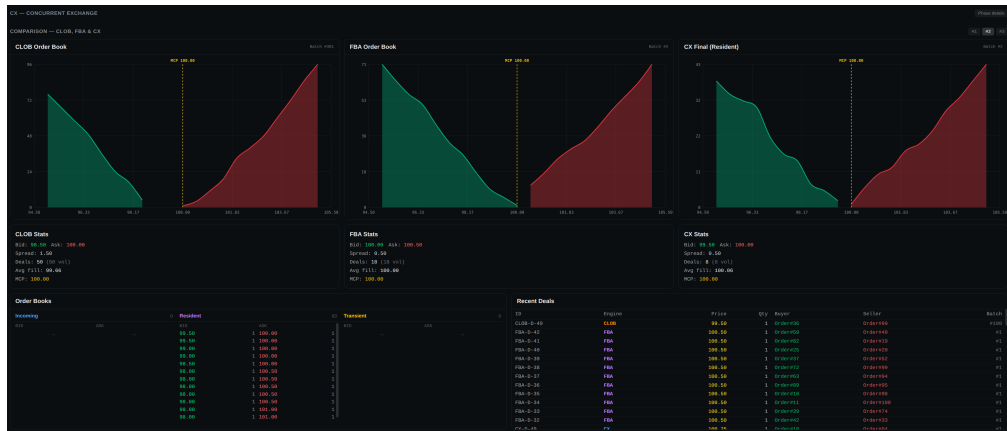
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- ▶ (not covered in this talk)

We conjecture several economic properties, e.g.,:

- ▶ Mitigation of front-running regular investors (non-HFT participants)
- ▶ Mitigation of sniping (i.e., the predatory removal of liquidity provider quotes)
- ▶ Better execution prices and increased profitability for regular investors
- ▶ Greater liquidity and narrower bid-ask spreads
- ▶ ...

Our prototype tool



Thank you!