

# Financial News

## Market mayhem one month on – a US perspective

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The flash crash on May 6 lasted only minutes but the debate into its causes and preventative measures continues. Financial News' US correspondent Shanny Basar rounds up some of the conclusions and opinions that reflect the mood of US regulators and market participants more than a month after the event.

- In about 20 minutes, starting at 14:40 EST, the Dow Jones Industrial Average dropped 998.5 points, or 9.2%, with some stocks and exchange-traded funds momentarily falling to almost zero before the index recovered to end the day 348.6 points down.
- During the crash, half of all stocks in the S&P 500 suffered an intraday loss of at least 10% and nearly \$700bn of market value was erased before the end-of-day recovery, according to Credit Suisse.
- Exchange-traded funds were more affected by the crash than any other type of security. Analysis of 116 ETFs on May 6 found that ETFs represented roughly 70% of all equity transactions cancelled by exchanges

(as a result of a price drop of more than 60% from 14:40 EST prices). The report by ITG, an agency broker, said: "It is not much of a stretch to say that liquidity fell to zero in relative terms and, on an ETF-by-ETF basis, that statement is literal in some cases."

The broker concluded that ETFs had attracted plenty of liquidity in other periods so it was unrealistic to believe the integrity of ETFs was somehow reassessed by the investing public in a matter of minutes.

Instead, ITG said: "Price discovery failed for ETFs during the crash, and the proximate cause was an extreme deterioration in liquidity, both in absolute terms and relative to individual securities in the baskets tracked by the ETFs."

- The US Securities and Exchange Commission started a wide-ranging review of market structure before May 6. There have since been several related regulatory proposals including:

1) A common data repository to collect real-time data across markets. It is estimated to cost \$4bn to build and to take three years to put in place, assuming the rule is finalised this year.

2) A trial period for stock-by-stock and market-wide circuit-breakers, which kick in when prices change dramatically. On June 3, Nasdaq OMX Group said it would expand circuit-breakers to all its US-listed stocks.

- Support for circuit-breakers is not universal. Credit Suisse believes implementation of circuit-breakers – which halt trading if a security moves by 10% in a five-minute window – will not prevent large jumps at the beginning and end of the trading day. It also warned that, with

breakers in place, normal events such as an acquisition or earnings announcement which commonly cause large price moves, could trigger a halt to trading.

- Investor confidence has waned. A survey of 145 market participants carried out one week after the crash by consultant Tabb Group found that barely half of the respondents had “at least a high degree of confidence” in the structure of the US equity market. Asset managers were the most negative, with only 7% having a high degree of confidence in market structure.
- The flash crash raises serious questions about algorithmic trading, according to Luis Aguilar, a SEC commissioner. “It’s self-evident in the wake of May 6 that even the people who wrote many of these programmes failed to understand how the algorithms would respond to trading initiated by the many other algorithms in the market,” he said.

The debate over high-frequency traders’ role in the market rages on:

\* George Sauter, chief investment officer at fund manager the Vanguard Group, speaking at a SEC roundtable on market structure on June 2, said high-frequency trading and dark pools contributed to a more efficient market but that May 6 highlighted flaws in an increasingly automated structure when liquidity vanishes.

\* **Sal Arnuk**, co-founder and partner at agency broker **Themis Trading**, said: “We are not surprised – and don’t see why anyone would be – that for-profit exchanges and alternative trading systems, which are frequently owned by brokers and high-frequency trading firms, cater to those firms in significant and unfair ways.”

\* Kevin Cronin, global head of equity trading at asset manager Invesco, said investors had no incentive to display publicly limit orders in most stocks because high-frequency traders would either join the quote or jump in front of it. He said: “Any examination of the events of May 6 will surely validate the vacuum of liquidity created by the lack of limit orders on the books. We also question whether high-frequency traders should be anointed yet as the modern-day marketmakers, given that it is unclear whether they are truly providing liquidity to the great majority of stocks in the markets.”

\* 62% of buy-side participants in the Tabb Group survey said they were negative towards HFTs.

• Likening the flash crash to birds striking the engines of plane and forcing an emergency landing in the Hudson River – as happened last January – Tim Mahoney, chief executive of Bids Trading, a block trading platform, said: “May 6 highlights that the role of people in our market structure is like that of a pilot. The majority of the time it can work on autopilot but we need a person for take-off and landing and to deal with turbulence. Experienced pilots who can deal with a double bird-strike are expensive.”