

BARRON'S

Anchovies in the Shark Tank

By Jim McTague

Saturday, April 30, 2011

In "Crapshoot Investing," his new book, Barron's Washington Editor Jim McTague explains how regulatory reform turned Wall Street into a casino, with the odds stacked against mom and pop.

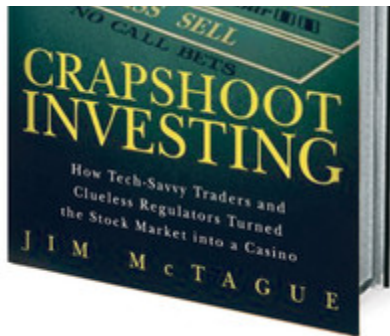
Crapshoot Investing, by Barron's Washington Editor Jim McTague, was published recently by FT Press. The book explores the rise of high-frequency trading, and the failure of regulators to curb its most harmful effects on the stock market. In the excerpt below, he describes two veteran traders' discovery of the new phenomenon.

Beginning in 2007, two longtime equities traders named Sal Arnuk and Joseph Saluzzi noticed some weirdly disturbing price movements in the stock markets as they observed trades on their multiple screens in a small trading room in quiet Chatham, N.J. When they went to hit a bid on certain exchanges, the price suddenly would disappear and a higher buy price or lower sell price would instantly appear in its place. It was as though some invisible, malign force was attempting to trick the traders into chasing the stock up or down the price ladder. Never before had they seen anything like it. The ghostly presence was so incredibly fast that there was absolutely no chance of the traders ever winning the game. If they took the bait then they would always end up paying more or getting less than the market's consolidated tape of prices had initially advertized.

The price jumps were aggravating. Arnuk and Saluzzi's job was to obtain the best execution price on large orders of shares for their institutional clients. Somebody was threatening their livelihood. Their firm, Themis Trading LLC, was named for a Greek goddess who personified fairness and trust. Someone subtly was trying to subtract these two attributes from the market, and this got their blood boiling.

The stock market always had provided a habitat for predators who exploit weaknesses and inefficiencies in its structure. If you didn't avoid these cold-hearted traders, you had about as much chance as an anchovy in a shark tank. The game of hide and seek was relentless. The predators always were probing for new weaknesses. If, for instance, they discovered through the grapevine that a seller had a huge inventory of stock to unload, they would short the stock, sending its price lower and costing the institution precious nickels, dimes and pennies. If they discovered that a mutual fund or a pension fund was attempting

to accumulate a large position in a stock, they would front-run the order, buying up the shares ahead of the bigger buyer and then selling the stock to the institution for a cent or two more than it would have paid if its intentions had remained secret.



Washington Editor Jim McTague draws a straight line from the SEC's implementation of Reg NMS to the flash crash of 2010. Along the way, two seasoned traders encounter and expose a form of market manipulation.

The funny business detected by Arnuk and Saluzzi was on a much higher level than the usual pitfalls faced by the traders. Ironically, the phenomenon had appeared just about the time the U.S. Securities and Exchange Commission, or SEC, had implemented its Regulation NMS—the abbreviation stands for National Market System—a sweeping reform aimed at increasing competition among the exchanges to both lower customer costs and make the stock market friendlier to long-term investors. Clearly there was a link. Intrigued, the two traders decided to dig into the matter.

As they began to track down the hombre, they learned just how radically Regulation NMS had changed the market, and it surprised them. The change had engendered an explosion in the number of high-frequency traders employing supercharged computers and advanced pattern-recognition and statistical software designed to beat the market. These guys always had been around but now there seemed to be a lot more of them, and their robotic trading machines were much faster than anything ever deployed in the markets. They programmed these over-clocked computers to make money buying and selling stocks without direct human oversight. There were hundreds of these robotic trading wunderkinds. Their numbers were growing every day because venture capitalists and hedge funds were bankrolling start-ups left and right. Clearly a lot of people thought that high-frequency trading was a path to easy profits.

ARNUK AND SALUZZI DISCOVERED THAT these new competitors had another significant technological advantage: Most of them possessed servers that were "co-located" at or near the exchanges. This meant that for a steep monthly rental a high-frequency trading firm was allowed to link its servers directly to the servers of the stock exchanges and get price and trading data milliseconds faster than anyone who couldn't or wouldn't spring for such a hookup, like retail investors.

HFT firms programmed their computers to hold stocks anywhere from two minutes to two days. Their object was to make a little money on each trade, not swing for the fence. It was a fairly predictable business because the shorter the

period under study, the easier it is to make forecasts based on historic pricing, volume and other data. Systems become increasingly unstable over time, which is why long-range weather forecasts are unreliable and hedge funds making multiyear credit bets lost their shirts in 2007. The lesson of 2007 had made a deep impression on so-called quants, which was short for "quantitative investors." They embraced HFT with religious fervor. Less risk equaled more money.

Based on Arnuk and Saluzzi's reading of the facts, high-frequency shops were using their superior computing power in new, devious and possibly unethical ways. Some of the strategies looked like barefaced attempts to manipulate the market. No one had noticed, least of all the SEC and examiners at the Financial Industry Regulatory Authority (Finra), an industry-financed outfit charged with policing brokers and the stock exchanges.

Arnuk and Saluzzi felt compelled to sound an alarm and bring their suspicions to the attention of the broader investing public. They wrote a white paper, "Toxic Equity Trading Order Flow on Wall Street: The Real Force behind the Explosion in Volume and Volatility." It read more like an op-ed piece than the academic treatise suggested by its title. Arnuk and Saluzzi offered no empirical evidence, just hunches. Hard evidence was tough to come by. The duo had 40 years of combined trading experience, however. They understood the mechanics of the market and they had seen hundreds of schemes designed to take advantage of unwary investors. They were convinced manipulation was occurring now on a grand scale.

THE SHENANIGANS HAD BEGUN IN 2007 when Regulation NMS took away the duopoly status of Nasdaq and the NYSE by allowing any exchange to trade listed securities. Previously, you could trade NYSE-listed stocks only on the NYSE and Nasdaq-listed stocks in the Nasdaq market. Now new computerized exchanges proliferated, anxious to get a slice of Nasdaq's and the NYSE's lucrative business. To survive in the face of the new competition, Nasdaq and the NYSE were compelled to go public.

Suddenly they were accountable to stockholders, who vocally demanded a decent return on their investment. The once-dominant exchanges had to fight tooth and claw against the new competitors for the trading volume they had lost. They soon discovered deep-pocketed customers in the form of the high-frequency traders, who were arbitraging price inefficiencies among the dozen or so equity exchanges and between the equities markets and the commodities markets. The NYSE and the Nasdaq solicited the HFT business, as did all of the other exchanges. They offered these prime customers special trading advantages as an inducement.

The charges by Arnuk and Saluzzi were sensational and potentially explosive. The markets were being manipulated. Regulators had been asleep. This was

outrageous, because the SEC and Finra were supposed to be cleaning up their act after missing abuses like Bernie Madoff's Ponzi scheme. But after the two traders disseminated the white paper, nothing happened—nothing at all. Investors in December 2008 had other things on their minds. They were consumed by bailouts, failures, bankruptcies and the incoming administration of Barack Obama.

Arnuk and Saluzzi were not quitters. In a follow-up white paper in July 2009 they warned of the possibility of a lightning-fast market collapse induced by high-frequency traders. Once again, few people paid attention. It sounded shrill and far-fetched. But this would change on May 6, 2010, when the robots would abet the fastest, deepest market crash in history—the Flash Crash.