BARRON'S

D.C. Current
SATURDAY, FEBRUARY 26, 2011

Slow Go on High-Speed Curbs

By JIM MCTAGUE

An SEC-CFTC panel might need at least a year to adopt rules aimed at preventing a second flash crash.

In December 2008, **Sal Arnuk** and **Joe Saluzzi**, stock traders who work in a quaint village office in sleepy Chatham, N.J., sounded a wake-up call about high-frequency trading. They contended that math and physics wonks who had programmed computers to buy and sell stocks near the speed of light were distorting prices and inflating volume data, and that markets could crash in minutes if one of their computer programs malfunctioned—say, by mistakenly going on a massive selling spree.

When the two were invited to Securities and Exchange Commission headquarters in 2009 to discuss their theories, they were amazed at how little the staff knew about the nature and extent of high-speed trading. The regulators dismissed them as a pair of well-intentioned quacks—until May 6, 2010, when **Saluzzi** and **Arnuk** were vindicated by what came to be called a flash crash, one of the most unsettling events in stock-market history. The Dow Jones Industrial Average fell about 700 points in 10 minutes, with some big-name stocks trading for as little as a penny. Sellers who'd placed market, rather than limit, orders were crushed. In the commodities markets, exchange-traded funds and S&P 500 e-mini futures fell so steeply that automated trading halts kicked in.

Since then, the SEC and the Commodity Futures Trading Commission have spent thousands of hours examining the May 6 event. On Feb. 18, a joint CFTC-SEC advisory committee recommended rule changes aimed at preventing another flash crash. Although the document is far from perfect, **Arnuk** says it shows that the panel and the regulators now understand that high-frequency traders have commandeered the stock market and radically altered the trading landscape, to the detriment of long-term investors.

"They now are focused on the right things," he says. One recommendation is that the regulators adopt a regime of pricing collars and circuit breakers for most stocks, stock options and stock futures to slow trading on days when panic erupts. Currently, a limited number of stocks are covered by such limits.

High-frequency traders program machines to buy and sell millions of shares of stocks, options and futures each day. Exploiting flickering price inefficiencies between markets or capitalizing on price direction, they make a penny here and a penny there, seldom holding a position for more than a few minutes. They fill a vacuum left by old-time human market makers, whose numbers have diminished. But unlike traditional market makers, they have no obligation to calm the market by buying when everyone is selling and selling when everyone else is buying. On May 6, 2010, these traders simply turned off their computers. Panic ensued because there were many more sellers than buyers.

The report recommends a rebate structure similar to a utility's peak-usage fees: it would encourage high-frequency traders to provide liquidity to the markets in periods of stress. It also recommends making it more expensive for big broker-dealers to internalize trades—that is, match a customer buy order with a customer sell order in-house—which drains liquidity from the exchanges.

The SEC plans to solicit public comment on the recommendations. **Arnuk** says the proposals are controversial, given that they could nickel-and-dime smaller high-frequency trading firms out of business. He predicts that the SEC and CFTC won't adopt any rules or curbs on high-frequency trading for at least a year. In the meantime, retail investors should realize that, when they submit a market order, they're sticking their necks out.