Algorithmic Rip-Off

Lightning-fast computers are burning investors

Reviewed by Jim McTague

Every time you buy or sell a stock, your pocket is being picked by the most sophisticated group of scoundrels ever to frequent that notorious clip joint known as Wall Street. If it were not for the two astute traders who wrote this breezy, instructive, and, ultimately, infuriating book, few of us would be any wiser.

In 2008, authors Sal Arnuk and Joseph Saluzzi, who run a small firm in New Jersey called Themis Trading, became curious when extreme, day-to-day volatility was roiling the markets. The conventional wisdom at the time attributed the wild gyrations to the global financial crisis; investors had become ultra-chary and were trading in and out of the markets to avoid a take-down by another crash. After sleuthing through market data, Arnuk and Saluzzi concluded that the conventional wisdom explained only part of the story.

They argued, in an intriguing white paper published on their company Website, that price swings were being exacerbated by a new breed of quants -- high-frequency traders -- programming lightning-fast computers to manipulate the markets. The greedy scientists, aided by inside information purchased from equally greedy stock exchanges and broker-dealers, were programming their wondrous machines to detect the direction of retail and institutional orders and to front-run them. In other words, if you had submitted a market order to purchase a stock trading at $10 per share, the high-frequency traders' computers would rush in and buy the stock ahead of you and sell it back to you at $10.01 -- in the blink of an eye. The HFT machines did this many millions of times an hour, and at the end of the day, the small change added up to very large bucks. Pensions and mutual funds were losing massive amounts and didn't even know it.

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At first, Arnuk and Saluzzi were ignored by the public and vigorously derided as Luddites by the exchanges and their lucrative HFT customers. But after the computer-assisted Flash Crash of May 6, 2010, a business press eager to unearth the causes began paying attention to their two-year-old warnings. Saluzzi was even invited to make his case on 60 Minutes, which did a report on the take-over of the markets by HFT trading machines.

The irony is that retail and institutional investors had believed that electronic trading had significantly reduced their trading costs, because that is what the exchanges and the broker-dealers had told them. Spreads--the difference between the bid and the ask price of a stock--had narrowed over the years from several cents to about a penny on the 1,500 most popular stocks. Retail customers had seen commissions shrink from over $20 per trade to $10 or less. We were told that the machines had added efficiency to the market and that we were enjoying the fruits of this technical revolution. All of us suckers should have known better. As Arnuk and Saluzzi note, "If you are a retail investor, there's a reason why
your online brokerage firm charges you only $8, or even nothing, for your orders. It's because they sell your orders to HFT firms who make money off of you."

Since the Flash Crash, there have been a number of high-profile, algorithm-driven market fiascos, the latest involving market-maker Knight Capital. The regulators are moving at a snail's pace to protect you from the high-speed threat. This instructive book by two outstanding whistle-blowers concisely explains how we sheep are being shorn and why we should be angry that the regulators are letting the predators get away with it.

**Broken Markets: How High Frequency Trading and Predatory Practices on Wall Street are Destroying Investor Confidence and Your Portfolio** BY Sal Arnuk and Joseph Saluzzi