

Commentary

SEC Measures To Prevent Flash Crashes Are Sensible, But Are They Enough?

By Michael W. Stocker, Electronically reprinted from May 20, 2010

Technological advances in the markets are overtaking the sleepy pace of government rule-making.



Courtesy of Labaton Sucharow LLP

On Tuesday the Securities and Exchange Commission (SEC) proposed temporary measures intended to prevent massive flash crashes like the 1,000-point intraday drop that shook equity markets May 6. While the plan is a sensible response to the recent crisis, the one-hour market crash is only part of a much larger problem regulators are facing. Technological advances in the markets, including high-frequency "flash" trading and naked access, are rapidly

overtaking the normally sleepy pace of government rule-making.

Even before the wild ride of May 6, market-watchers worried that existing safeguards built into the exchanges were rapidly becoming obsolete. By the end of last year, more than half of U.S. equity trading volume consisted of high-frequency trading, in which firms profit by using supercomputers to make trades milliseconds before other investors. While such rocket-booster trading has been enormously profitable for companies like **Goldman Sachs** (GS), it also potentially enables market participants to game the system by trading ahead of existing buy or sell orders.

Another recent technical trading development, the phenomenon of naked access, only increases the potential for mischief in high-frequency trading. Naked access permits high-speed traders to anonymously make trades on exchanges using a broker's computer code. While naked access provides a valuable speed advantage for traders, it also lets them operate under a cloak of invisibility, shielding them from regula-

tory scrutiny.

Earlier this year these concerns led SEC commissioners to unanimously approve proposed rules that would require brokers with market access, including those who sponsor customers' access to an exchange, to put in place risk management controls and supervisory procedures. The proposed procedures would help prevent erroneous orders, ensure compliance with regulatory requirements and enforce pre-set credit or capital thresholds.

The May 6 debacle, which saw more than a trillion dollars of market capitalization temporarily disappear, has made it apparent that the threat of erroneous orders and other computer-generated trading mistakes is far from theoretical. As the markets tanked and then partially recovered between 2:30 and 3:00 pm, individual components of the Dow Jones industrial average gyrated even more wildly, with **Procter & Gamble** (PG) experiencing an astonishing drop of 37%.

Even more strangely, values for some stocks, including **Accenture** (ACN),

simply evaporated, dropping from over \$40 at the opening to a penny a share before recovering. These bizarre swings resulted in exchanges canceling en masse any trades between 2:40 and 3:00 where trade prices wildly diverged from previous trades.

In a joint report by the SEC and the Commodity Futures Trading Commission, also released Tuesday, the regulators reported that their investigations into the causes of the temporary crash were inconclusive. While there is still lively debate over the origins of the crisis, ranging from cascading stop-loss orders to a probably mythological "fat fingered" trader who entered "billion" rather than "million," it is apparent that innovations in trading may be overtaking safeguards currently built into the system.

In May 11 congressional testimony regarding the May 6 crisis, SEC Chairwoman Mary Schapiro focused on the liquidity replenishment points or "speed bumps" built into the NYSE's trading system, a device intended to slow

automated trading when markets become too volatile. While these speed bumps may have slowed trading on the exchange for some careening stocks on May 6, they likely resulted in orders being routed to other exchanges without trading halts in place.

To address this issue, the SEC, the Financial Industry Regulatory Authority and the heads of the exchanges worked together on new rules to deal with volatility that would apply across all regulated exchanges and alternative markets.

The proposed rules call for "circuit breaker" measures that would halt trading in individual S&P 500 stocks showing signs of extreme volatility. Under the rules, exchanges would be required to pause trading if stock prices moved by 10% or more in a five-minute period. While individual exchanges would be permitted to implement different rules to slow trading, they would all be required to act if trading in a stock meets this volatility criteria.

Coordinating responses among the exchanges is key to ensuring that any trading halt not simply displace the problem to a different market. After a 10-day comment period, the proposed rules will be given a trial run in a pilot program scheduled to last through Dec. 10.

While some may criticize the efforts to coordinate comprehensive circuit breaker rules as treating the symptoms before the disease has been diagnosed, the pace of change in the markets no longer permits rule-makers to sit at the sidelines. Moreover, test-driving rule changes through a pilot program will offer the opportunity to refine changes without committing to a new regulatory regime that might bring unexpected consequences. With luck, the proposals will at least buy some time for regulators and investors, and that is a vanishing commodity in 21st-century markets.

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