

**Your on the
Street Reporter**



Uyless Black

**Epilogue X to *The Nearly Perfect Storm*
Dark Pools and Dark Accountability**

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Preface

My intent in writing *The Nearly Perfect Storm: An American Financial and Social Failure*, and these epilogues is to spark your ire. I am not one to compose inflammatory compositions. I began my studies of the 2008 financial crisis with a neutral view of the subject, perhaps even skewed toward the financial world (specifically, the investment banking industry), reflecting my former employment at the Federal Reserve.

No longer. The more I learned about the institutions and individuals who were involved in the meltdown, the more disgusted I became. I wish this turn of events had not come about. I wish I had found the Great Recession occurred because of a downturn in a conventional business cycle. It did not.

Do not expect this series to be light-hearted, although I will attempt some gallows humor to lighten the load.

The Nearly Perfect Storm: An American Financial and Social Failure
Epilogue VIII: Dark Pools and Dark Accountability

“...people [on Wall Street] who make the most money want the least clarity possible.”¹

“No one today could claim with a straight face that anything remains of the so-called ‘efficient market hypothesis.’ ”²

April 13, 2014

The Wall Street scandal about many high frequency traders that has unfolded over the past few weeks has caught the attention of even those who do not follow Wall Street activities. Two weeks ago, I posted “In a Split Second [I],” with an emphasis on the computer communications aspect of the subject (available at Blog.UylessBlack.com). For this report, I hope to clarify the financial and ethical aspects of the some (not all) high frequency traders who have gamed the system, often at the expense of their own customers.

You read the last sentence correctly: at the expense of their own customers. Yet, as explained in this report, they may not have broken any laws, at least from a narrow interpretation (and their rationale) of current laws.

In *The Nearly Perfect Storm: An American Financial and Social Failure*, I wrote on page 232 about a topic that made the lead story on *60 Minutes* and Charlie Rose a couple weeks ago. The addendum to this report provides quotes from the book. It is the same text that was in “In a Split Second [I].” I place the book’s text in an addendum due to its length, and the addition of an example.

(Using a dark pool described in this article does not necessarily mean high frequency trading is involved. However, in practice, high frequency trading is needed to make these ideas function better.)

Suppose you were to learn that a Wall Street bank with whom you do business made trades in the stock market at your expense?³ (at a customer’s expense, that is, trading against the firm’s customers) What if you learned these trades were made in secret on private exchanges, even out of sight of regulators (the Securities and Exchange Commission (SEC))?⁴

Suppose you learned that a 2005 SEC rule (Regulation National Market System [NMS]) provided a way for the bank to supposedly justify its actions? Further, that the expense to you was taken as profit by your bank and the bank’s trading partners?

What if your bank did not send your buy order to any exchange but its own private exchange (the bank’s dark pool)? This action might preclude finding a better buy in the full marketplace,

¹ Michael Lewis, *Flash Boys* (New York, W.W. Norton), 211. A quote from Brad Katsuyama.

² Tony Judt, *Ill Fares the Land* (New York, Penguin Group, 2010), 36.

³ Lewis, *Flash Boys*, 264.

⁴For a good reason, these private exchanges are called *dark pools*.

thereby, keeping the transaction between only two of its customers; therefore, denying you a possibly higher yield?⁵

Figure 1 shows one of these actions. You (Party A) wish to buy stocks at the going rate. A seller (Party B) who is also customer to your broker wishes to sell at \$100.01 a share. The broker goes to the dark pool first even when another exchange offers a better price for your offer (Party C).

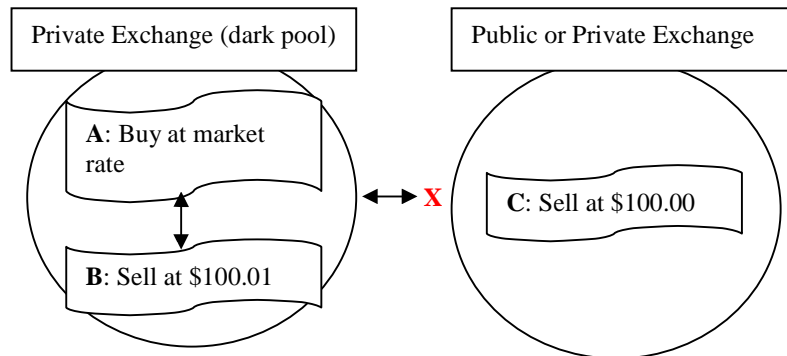


Figure 1. A closed transaction.

These actions demonstrate what happens on many transactions in America’s stock market. The actions have nothing to do with adding value to America’s financial system. At the end of the day, these traders have contributed nothing to anything but their own net worth. The Royal Bank of Canada did an analysis: “...if it opened a dark pool and routed all its clients’ orders into it first, [the bank] would save about \$200,000 in exchange fees.”⁶

Or as Lewis writes, “Morgan Stanley wanted to be able to trade for itself in a way it could not trade for its customers; it just didn’t want to seem as if it wanted to.”⁷

For high-frequency traders, they intercept buy orders before others (by virtue of being closer to an exchange. [See “In a Split Second [I].”) They buy pieces of the order then sell them at a slightly higher price to this buyer or other buyers. It’s a very small transaction, but when this kind of trade is done millions of times a trading day, it adds up to millions of dollars in profit.

I am told my criticism is not correct, that these traders, with all these transactions, add liquidity to the market. I am naïve about this subject, but it seems to me that they do little else but add a dangerous volatility to the market. The crash that occurred a few years ago is just such a warning sign.

As said by Tony Judt, “If we cannot trust bankers and brokers to behave honestly...then capitalism itself will grind to a halt.”⁸ But we should not expect such rose-colored glasses behavior. Competition will always lead someone to break the rules. We wish it were otherwise,

⁵ Lewis, *Flash Boys*, 228.

⁶ *Ibid.*, 41.

⁷ *Ibid.*, 19-20.

⁸ Tony Judt, *Ill Fares the Land*, 38.

but it is not. We wish we did not need the SEC, but we do. If only SEC would do its job. It failed miserably during the lead up to the Great Recession.

Nonetheless, I do not see how the activities depicted in Figure 1 are anything but downright fraud. I trust you hold the same view. But then we are not regulators. You and I (well, I am anyway) are small players in the stock market who are once again getting the short end of the stock stick.

Addendum

Quotes from *The Nearly Perfect Storm* about the issue.

Page 232:

High-Frequency Trading

High-frequency trading creates volatility in the marketplace. It gives the term *short* in short-term speculation a meaning beyond what many people can comprehend. It uses powerful computers to engage in millions of trades during a very short time, in mere seconds; more often, in fractions of seconds. Short term? Millions of dollars can be made by making trades and flipping stocks within a millisecond window.

Sometimes, it is even less. Nanosecond windows are not that big a deal when dealing with the speed of computers. Paraphrasing from Duhigg:⁹

For most of Wall Street's history, stock trading was fairly straightforward: buyers and sellers gathered on exchange floors and dickered until they struck a deal. In 1998, the SEC authorized electronic exchanges to compete with marketplaces like the New York Stock Exchange. The intent was to open markets to anyone with a desktop computer and a fresh idea.

But as new marketplaces have emerged, PCs have been unable to compete with Wall Street's computers. Powerful algorithms execute millions of orders a second and scan dozens of marketplaces simultaneously. They can spot trends before other investors, changing orders and strategies within milliseconds.

Loopholes in market rules give high speed investors an early glance at how others are trading. And their computers can essentially bully slower investors into giving up profits—and then disappear before anyone even knows they were there.

In addition, these traders can make a boatload of money just by trading, regardless if they lose or gain on the transaction. Stock exchanges pay a small fee to big volume traders. Spread over millions of shares, the income can be millions of dollars. Thus, the game is gamed to encourage even more frequent trades. Nice work if you can get it. In 2008, high-frequency traders turned a profit of about \$21 billion.

As an example:

Consider that the market for P&G shares is 80-80.01 [80 to sell and 80.01 to buy], and buyers and sellers sit on both sides of all of the exchanges. A big seller comes in on the NYSE [New York Stock Exchange] and knocks the price down to 79.98-79.99. High-frequency traders buy on NYSE at 79.99 and sell on all other exchanges at \$80, before the market officially changes.¹⁰

⁹Charles Duhigg, "Stock Traders Find Speed Pays, in Milliseconds," *The New York Times*'s website, July 23, 2009. This general discussion is sourced from *The New York Times* correspondent Duhigg's article.

¹⁰ Lewis, *Flash Boys*, 172.

Consequently, the sooner the trader sees this sell, the sooner he/she can get ahead of others. It is not necessary to get rid of high frequency traders. That is not the core problem, although I fail to see what they really add to the economy (Again, I am told: liquidity.). The problem, as stated in this report, is that these traders get ahead of others and often exploit the natural marketplace and unwary investors, especially if a trader trades at the expense of one of its investors.