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# Living With High-Speed Trading, Part II

## The right way to treat an errant algorithm.

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Among the many innovations of the high-frequency traders, the most audacious certainly would have been getting a do-over when their computer algorithms screwed up and bought the wrong stocks at the wrong price.

That was the proposal of Knight Capital after Knight's computers went haywire in last week's famous 45-minute trading snafu. Correctly, Mary Schapiro of the Securities and Exchange Commission said, "No way." Instead of being allowed to cancel the disastrous trades, Knight had little option but to turn to vulture capitalists to fill a $400 million hole and keep itself afloat.

Hooray. This is not a small moment in accommodating the rise of electronic trading platforms.

Though it happened much faster, Knight's screw-up was not materially different from MF Global's, J.P. Morgan's or anyone else's screw-up in making unwise or unsustainable bets in the securities markets. Knight lost money. Others took advantage. The blogs have been full of traders claiming to have scored big trading against Knight's rogue algorithm

Were there collateral victims? In all cases, probably, yes.

Anyone who made a leverage bet on European bonds might have faced an uncomfortable moment when MF was forced to dump its position at a loss. Ditto anyone who was on the same side of the corporate credit trade as J.P. Morgan's "whale." And ditto any investor who ordered his broker to sell Goodyear or Exelon if the price fell by 10%, never guessing the reason would be Knight's misguided computers driving down the price.

That's tough. But users of stop-loss orders took that risk even before high-speed trading. An errant rumor, some millionaire dumping shares to fund his divorce settlement—lots of things can cause a trading blip.

High-frequency trading, in short, is mainly discomfiting to traders and speculators, not to those we think of as investors—who concern themselves with a company's long-term performance. It's discomfiting to those who buy on margin, who bet on short-term price moves, who follow

complex trading strategies that can be spoofed by passing market hiccups like those caused by Knight's runaway algorithm.

But notice that Knight was not a replay of the BATS IPO screw-up, or Nasdaq's Facebook fiasco, or even the 2010 flash crash—all of which implicated exchange systems. In the case of Knight's algorithmic blunder, the exchanges behaved as they should—accommodating Knight's foolish orders, finding buyers and sellers to take the other side.

Naturally, those who ply the markets have various and conflicting regulatory agendas when it comes to high-speed trading. Naturally, all couch their positions in terms of "investor confidence" and the "little guy."

Say two of the most articulate critics high-speed trading, Sal Arnuk and Joe Saluzzi of Themis Trading, in their blog: "Would a slightly slower marketplace with $20 retail commissions and 2 or 3 penny spreads . . . be a really bad thing? Would such a market be worth getting investor confidence back, and hundreds of billions of investor dollars back into the market?"

Messrs. Arnuk and Saluzzi's critique is worth considering, but they surely end up overpromising. What has always been true remains true. Retail money will be plentiful at the top of bull markets and scarce at the bottom of bear markets. It has nothing to do with confidence in market plumbing. The "confidence" that sucks in the retail investor is the age-old, and usually ill-timed, triumph of greed over fear.

In the meantime, nanosecond trading doesn't interfere with the information processing role of the market—the weighing of company prospects and sending of signals to management.

Nanosecond trading, on balance, has improved liquidity and reduced transaction costs, while stimulating inter-exchange competition—not worthless gains.

Even Wired magazine, whose latest cover story details the fascinating and wacky pursuit of microsecond trading advantages via fiberoptics, trots out a professor, Baruch College's Bernard Donefer, to remind us: "At the end of each trading day, equities wind up in the hands of people who want to hold them for appreciation or for dividends."

That's not to say our markets are perfect or aren't regulatory constructs that could be improved upon. If exchanges were truly free to organize their businesses as they see fit, our markets would likely look different than they do today. If exchanges were less answerable to government and more answerable to the companies who list their shares, it's quite possible a different balance between speed and stability would be struck.

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