Opening Remarks
What's the Rush?

The American financial system is erratic and voracious, and keeps score in milliseconds. Here's how to rein in the beast.

By Peter Coy

Shares of Accenture, the big tech consulting firm, were selling for $40 on the afternoon of May 6 when the stock suddenly seized up. For 22 seconds there were no recorded trades. Then came a transaction below $10. In the next eight seconds, Accenture quivered like a fibrillating heart, its price changing more than 80 times before flat-lining at one penny. Then just as abruptly—"Clear!"—the share price rebounded to $40 and stayed there. The super-low trades have since been reversed by the exchanges but the record of them lives on in Bloomberg's database.

Accenture was just one of the many companies whose shares were wracked by the May 6 crash, known to many as the "flash crash," which briefly reduced the value of U.S. stocks by more than $800 billion. The vast liquidity that automated trading systems supposedly provide the stock market vanished instantly that day, as computer programs shut down in confusion. Now it's becoming clear that May 6 was not a one-time convolution. The New York Times reported on Nov. 9 that more than a dozen individual stocks, including Progress Energy, Citigroup, and Washington Post Co., have suffered mini-crashes in the months since. As Andrew W. Lo, director of the Laboratory for Financial Engineering at Massachusetts Institute of Technology, told the Times, "The U.S. equity markets have become the Wild, Wild West."

There's a familiar—and odd, and unfortunate—echo here. Banks on Wall Street and Main Street overleant, leading to the worst economic downturn since the Great Depression. Then they got bailed out. Then they paid big bonuses. Now they are cranking up their trading operations in a way that imperils the financial system once again. Gary Gensler, a former Goldman Sachs executive who heads...
the Commodity Futures Trading Commission, last month compared one firm's trading strategy in the May 6 crash to driving on "autopilot into a ravine."

Fixing this is not a matter of patching up the current system, as the Securities and Exchange Commission is already doing (see page 56). It's time to step back and consider the proper role of finance in the American economy. Right now finance is an erratic master. It ought to be a quiet, efficient servant.

Harvard University economist Benjamin M. Friedman asks the right question—"Is our financial system serving us well?"—in an essay in the fall 2010 issue of Daedalus, the journal of the American Academy of Arts and Sciences. Friedman points out that from the 1950s through the 1980s, profits earned by financial firms excluding insurance and real estate accounted for 10 percent of total U.S. profits. Finance's share of profits grew to 22 percent in the 1990s and to an astonishing 34 percent from 2001 to 2005. Fantastically high salaries and bonuses attracted more than a quarter of Harvard's graduating job seekers to investment banks, hedge funds, private equity firms, and the like. That, Friedman notes, was "just before the surge in borrowing, securitization, and derivatives finance began to transform itself into a world-class crisis."

The bigger the financial sector gets, the more dangerous it becomes. The high-frequency trading that contributed to the May 6 crash is a case in point. High-frequency traders are engaged in a costly technological arms race to decrease the "latency" of their trades so they can exploit fleeting arbitrage opportunities before their rivals do. Peter Duffy, chief technical officer of Glasgow-based Sumerian, a trading analytics firm, says one of his firm's clients in the City of London has more computing power in one segment of its equity trading operation than the entire British nation had in 1885. In high-frequency equity trading, says Duffy, the goal is to take in market data, process it, and get a buy or sell order back out all in less than 2 milliseconds.

These vast resources are being spent on a zero-sum game. Any incremental gain for the seller is a loss for the buyer, and vice versa. Backers of high-frequency trading say they add liquidity to the market, making it easier for ordinary investors to buy or sell without causing the market to move against them. But liquidity is worth nothing if it goes away when it's most needed, like a swimming pool that dries up just as you jump off the high dive. In the May 6 crash, spreads widened beyond belief. Trades were done at prices from as low as one penny a share to as high as $100,000 a share.

One proposed solution gathering support is a transactions tax—possibly just a few cents per $100—that would throw sand into the gears of high-frequency trading. The European Parliament came out in favor of the concept earlier this year. Britain already has a half-percent "stamp duty" on stock sales that traces its origins to 1694; it hasn't kept London from being one of the world's chief financial centers.

Last year in Pittsburgh the G-20 leaders asked the International Monetary Fund to look into the idea of taxing stock sales. In a detailed review released in September, IMF economist Thornton Matheson concluded that a global transactions tax would be feasible, though not the ideal solution either for raising money or for dampening debt-fueled speculation. "The buildup of hidden financial risks in the recent crisis," Matheson writes, "resulted predominantly from excess leverage, risk concentration and product innovation such as asset securitization, which would have been largely unaffected by a transactions tax."

Maybe the answer is something more drastic than a transactions tax. As Matheson writes in the IMF document, there are other options for attacking debt-fueled speculation. These include demanding higher margin and collateral or taxing debt on the balance sheet, which would encourage companies to sell shares to pay down debt. Or limiting the deductibility of corporate interest payments so companies are no longer encouraged to load up on debt. Market structures could be made safer, too. Adam Sussman, head of research for the TABB Group, a New York-based financial markets research and advisory firm, says the high-frequency arms race was inadvertently launched by the SEC itself in 2006 when it approved a regulation allowing exchanges to bypass other exchanges that didn't respond quickly, even if they had the best prices. Says Sussman: "The SEC was basically guaranteeing that we would see more strategies that depended on speed."

Any effort to make finance safer, especially via new taxes, will be vociferously opposed by Wall Street and the banks, whose profits are amplified by leverage. Of course, the financial industry has powerful allies in Washington. When the SEC toughened its trading rules after the crash last May, Eric Cantor, who's set to become House majority leader, scolded the agency. "I am concerned that this was done before conducting a holistic review of the causes of the disruption," Cantor, a Virginia Republican, wrote to the SEC on May 21, Bloomberg News reported on Nov. 9 that high-frequency trading firms with names like Getco, Hard Eight Futures, and Quantal Financial have more than quadrupled their political giving over the last four years; Cantor was one of the high-frequency traders' top recipients, getting $23,000 since the start of 2009 for himself and his political action committee. (Cantor wasn't available to comment for the Bloomberg News story, his spokesman John Murray said.)

Most taxes are a necessary evil. Taxes on labor income discourage work. Taxes on dividends and capital gains discourage investment in new factories, office buildings, equipment, and software. What would new taxes on Wall Street discourage? High-frequency trading and overleveraging. Hmm. They just might be the rare taxes that the public would support.

—With Jesse Westbrook, Robert Schmidt, and Frank Bass