

Invisible predators*

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Michael Lewis:

Flash Boys

A Wall Street Revolt

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When we try to find samples for real, intensive market competition in relation to the economy, the stock markets come to our mind as one of the first things. On stock markets everything is public, the information flow is fast, everybody has the same information at the same time, and consequently the chances are balanced. Here indeed, those win who are better, since equal conditions are provided by strict regulation and the evenness of competition is also proven by the lively rhythm of the stock exchange as the need for being quick arises from the fact that competitors are always very close to each other in tight competition.

However, there is a world hidden for simple investors where quickness and, through it, the public information flow providing the same guidance for everyone also receive different interpretation. The book of Michael Lewis presents this world, the world of high frequency trading.

In this world the largest investors, professional investment funds, huge pension funds and, in a certain sense, even the large banks of Wall Street are vulnerable to small but very fast, new type predators who are mostly invisible to the others and who mainly came from mathematics, computer technology, atomic physics or other sciences rather than the financial world. In this world, time is measured in millionth of seconds and in the interest of that, astronomical amounts are spent on technology. Paradoxically, this world was established as a result of a regulation aimed at the equality and balanced character of the conditions of electronic trading that just began at the stock markets in the 1980s and became exclusive since that time.

* The views expressed in this paper are those of the author(s) and do not necessarily reflect the official view of the Magyar Nemzeti Bank.

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Learning from the experiences of earlier abuses, in order to eliminate them, the US Securities and Exchange Commission tightened the rules of electronic trading in 2005. The regulation on the National Market System made the acceptance of the best priced offers compulsory and ordered to build a central system for collecting, processing and publishing all buy and sale bids of the different stock exchanges. However, it has not specified how fast this central system must be. Thereby, building faster information processing systems, it facilitated high frequency traders in reaping the benefits from the speed to come before the other operators of the market in the manner that, making use of the requirement of compulsory acceptance of the best offers, they receive information on their intentions as well. Thanks to this deadly mixture created by the otherwise good-intentioned regulation, the new type operators who build faster and faster systems, increase the volatility and risk of the markets by their abstruse strategies, who meanwhile basically do not assume any own risk pick billions of dollar from investors' pockets.

However, the book of Michael Lewis shows not only the establishment, operation and special internal rules as well as the harmful effects of this world, but also the work of a small but enthusiastic team of Wall Street professionals acting against them and, through it, also the possible solution. The group organised around Brad Katsuyama who left his well-paid executive job at the Royal Bank of Canada, a Canadian bank considered to be a small player on Wall Street, and composed of professionals who, similarly to Brad Katsuyama, had left the safety of their well-paid Wall Street jobs confront the predators who dominate the market and also have strong political relations. Initially, searching the causes of phenomena disturbing their own trading or just their technical work, they gradually explore the world of high frequency trading and finally, they decide to confront it. They seek allies in the investors injured by the system that has evolved and, assuming serious risks, they establish their own stock exchange that allow investors and brokers to avoid the system contaminated by the high frequency trade. For this purpose, they partly apply their own weapon, speed, against them, and partly they create conditions under which extraordinary fastness cannot become a source of an unfair advantage.

The story ends with the establishment and the first successes of the new stock exchange, however, the fight for restoration of the fairness of the competition on the stock markets and for change does not end.

The book of Michael Lewis is an interesting and exciting reading for those who are interested in the backstage of stock exchanges, the possibilities of technology, or the difficulties of regulating the capital markets. Despite the exciting and maybe unsettling topic, the book is also an enjoyable read; the bestselling author does his best in it.