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How Elizabeth Warren would have stopped a panic on Wall Street

By Max Ehrenfreund April 23

British authorities arrested an investor named Navinder Singh Sarao on Tuesday, almost five years after, U.S. regulators allege, he helped bring about a momentary nationwide financial panic by manipulating a futures market in Chicago.

According to the complaints against him, Sarao pocketed $879,018 on March 6, 2010, the day of the "flash crash." Since then, he allegedly continued his fraudulent behavior. That regulators failed to act against him for so long again raises questions about whether financial cops in Washington and referees on the exchanges in New York and Chicago can protect investors from manipulation, at a time when automated trading programs buy and sell securities faster than any human trader can react.

Prosecutors say Sarao's technique relied on a software program that placed and canceled large orders within fractions of a second, creating very small fluctuations in the prices of securities. He took advantage of these fluctuations by buying and selling just as quickly, realizing minuscule profits that mounted with each trade.

[How one automated trade led to stock market flash crash]

To eliminate this kind of deception, Democrats in Congress have advocated a small tax on every financial transaction, amounting to a few pennies on every $100 in securities traded. Those pennies would add up for someone using Sarao's technique, making it a losing game.

In a speech last week, Sen. Elizabeth Warren (D-Mass.) reiterated her support for "a targeted financial transactions tax designed to have no impact on regular mom-and-pop investors."

A number of experts have suggested that the technique described in the complaints is not uncommon, and others said any contribution Sarao might have made to the events of that day was probably small.

"Sarao had nothing to do with this," said Eric Scott Hunsader, the founder of the financial data company Nanex. He said the trader's actions might have exacerbated the situation but argued that the blame for the crash lay with regulators for allowing widespread manipulative and reckless behavior.

"They haven't been on the beat," Hunsader said.

In addition to charges of fraud and manipulation, the Justice Department accused Sarao of "spoofing," a crime defined by the Dodd-Frank financial reform law. The law remains politically contentious. Liberal and conservative critics argue that it protects banks, which for their part object to what they see as intrusive regulation.

Spoofing describes the practice of placing orders to buy or sell a security in order to dupe other investors into feeling optimistic or pessimistic about that security and then canceling the orders before they can be executed.

For example, seeing that a spoofer has placed orders to sell, other investors might begin to worry that the price of an asset is falling. They might sell, and the price actually would fall. The spoofer then cancels his initial orders and buys the asset at the reduced price. When the impression created by the spurious orders fades and the price drifts up to its true level again, he can sell at a profit.

The government accused Sarao of using these techniques hundreds of times over the past several years, including on the day of the flash crash, when he was trading futures in stocks on the Chicago Mercantile Exchange.

On that day, the value of the Dow Jones Industrial Average plummeted 1,010.14 points, losing most of that value in an interval of about 2½ minutes, before making up the losses almost as quickly. Shares in several major corporations were briefly trading at a penny a piece.

[Is high-frequency trading a threat to stock trading, or a boon?]

Yet those other occasions on which Sarao allegedly spoofed investors did not also result in panic on the stock market. A spokesman for the Commodity Futures Trading Commission, Steven Adamske, told The Washington Post on Tuesday that while Sarao was not the sole cause, he "helped create the imbalance and the circumstances by which the flash crash happened."

His actions were never a secret. Officials at the exchange had been aware of what Sarao was doing since 2009, and, on the day of the crash, they politely reminded him about the rules, according to the Justice Department's criminal complaint. (The CFTC filed a separate civil action.)

According to the complaint, Sarao later wrote to his broker, saying he had called the exchange and, using an obscenity, asked it to leave him alone. Apparently, it did.

"The CME has some explaining to do, and so does the CFTC," said Craig Pirrong, an economist at the University of Houston who studies manipulation.

In a statement Wednesday, the exchange said trading in futures had not been responsible for the flash crash. "Nothing is more important to CME Group than the integrity of our marketplace," the statement read.

Pirrong said manipulation can be hard to spot. Traders can have legitimate reasons for canceling orders, and the sheer volume is more than regulators and exchange officials can handle.

"The amount of data to sift through to try to pick out patterns is pretty daunting," he said. "Particularly in an electronic trading context, distinguishing potentially manipulating strategies from non-manipulating strategies is difficult inherently."

Determining just how common such strategies are is difficult, too. Critics of what is known as high-frequency trading say that abuses are prevalent. Nanex's Hunsader compared Sarao's alleged offenses to driving above the speed limit — dangerous and illegal but routine.

Albert Menkveld, an economist at Vrije Universiteit Amsterdam who has studied the crash, said he has not seen much evidence of fraud.

"There's this huge angst around this type of trading," he said. "People always forget that there all these benefits that arise when we automate intermediation in the securities markets."

All the same, he said, manipulation is a real danger and authorities should be "vigilant" in combating it.

Democrats' proposed tax is a simpler approach to stopping manipulators. Yet many legal activities also might become unprofitable, and trading strategies have become common on Wall Street as more sophisticated technology has allowed investors to trade securities cheaply and almost instantaneously.

Pirrong said such a tax would be "an awful idea." It would discourage investors from buying and selling, making markets effectively smaller and more prone to fluctuations. In the parlance of economists, financial markets would be less liquid.

"Financial transaction taxes are toxic to liquidity. They're like kryptonite to liquidity," he said.

Dean Baker, a director of the liberal Center for Economic and Policy Research who has long advocated a tax on financial transactions, said that objection is unfounded.

He said the tax could be so small that it would not make the market meaningfully less efficient, any more than the higher costs of trading did two decades ago before technology made it so cheap to buy and sell securities.

"We're just talking about going back to transaction costs to where they were 15 or 20 years ago," Baker said.

"We're covering ground where we've been in the recent past."

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