Search American Banker
for Go
About the Banking Group

Welcome, Alfonso Esparza Log Out

Thursday, May 27, 2010, as of 02:38 PM EDT

Today's Paper | Tools & Data | Topics | BankThink | Conferences | My Account | Custom Email | Feedback | Contact | RSS

- Cards/Payments
- Community Banking
- Markets
- Mortgages
- National/Global
- Retail Delivery
- Technology
- Viewpoints
- Washington/ Regulatory
- Wealth Management
- Mobile Banker
- News by State
- Blogs & Scans
- Special Reports
- Company Index
- Resources
- Customer Service
- Advertise/Media Kit
- Conferences
- CareerZone
- Marketplace
- White Papers
- Banker of the Year/ Best in Banking
- Financial Services Executive Forum
- The FinTech 100
- 25 Most Powerful Women in Banking
- The Innovators

Viewpoint: SEC Has to Make Good on Pledge to Stop Flash Orders and Dark Pools

American Banker | Thursday, May 27, 2010

By Michael Stumm

Print Email Reprints Feedback RSS

Technology is central to the growth of the securities industry. The introduction of protocols and standards such as the CUSIP security identifier and the FIX protocol enabled automation and reduced the level of manual intervention required to process transactions. With the efficiency resulting from automation, financial institutions could handle more transactions at a lower cost and they could open their trading to a new class of investor who, despite being less wealthy than the traditional type of investor, has become increasingly important for firms. Welcome to the age of the discount broker.

Opening the world of self-directed investing to the middle class is just one example of how technology has benefited the entire industry. Unfortunately, a winner-takes-all IT arms race is on, one that threatens the very future of the markets.

Last year, during the worst of the recession, the Senate brought pressure on the SEC to ban two practices deemed to be particularly dangerous to the integrity of the markets. The first of these — known as flash orders — is a practice whereby select trading firms get to see market prices for a split second before the rest of the market. The firms pay a fee to the exchange for the privilege of this sneak peek and, using powerful computers with proprietary algorithms, place trades based on the advance information they receive from the exchange. It only stands to reason that these trades have a much better chance of being profitable than ones issued by traders who do not have the same level of access to the price information.

Similarly, the term "dark pools," also known as dark liquidity, refers to liquidity that is deliberately hidden from the market. Dark pools exist as interconnected networks where institutions trade amongst themselves, over the counter. Trading in this manner reduces the impact these transactions could have on the price of an exchange-listed security, allowing large investment firms to trade massive positions without tipping their hand to the market. This minimizes the potential for price volatility and favors the large investment firms participating in the dark pools, to the detriment of the rest of the market.

Because dark pools provide Wall Street's largest firms with yet another advantage, their use has risen in popularity over the past decade. Goldman Sachs, for instance, is said to operate a dark pool known as Sigma X that some critics contend was instrumental in leading Goldman to record profits on its proprietary trading desks in 2009.

With controversy over the use of dark pools and flash orders brewing, the SEC last August promised to eliminate these unethical practices. Unfortunately, nearly a year after this pledge, both practices are still in use and the SEC has yet to take concrete action against either behavior.

There are plenty of examples of how technology can be used to ensure fairness for all market participants. A strong case study is the online foreign exchange industry. As a market maker and currency data provider, my company believes all forex traders should be treated

RELATED ARTICLES

- Viewpoint: Desperate Times Call for Financial Creativity
- Feedback: ShoreBank Didn't 'Earn' Infusion
- Column: Industry Values Key to Reviving Trust
- Viewpoint: Adapt to New Consumer Needs
- Viewpoint: Don't Crimp Banks' Lending Capacity

Most Popular | Viewed | Emailed

1. Reg Reform Bill Misses Opportunity to Overhaul Agencies
2. Democrats' Reg-Reform Conference Choices Bode Ill for Banks
3. Bank of New York Mellon Picks New Wealth Chief
4. An eBay-Like Receivables Site Eases Liquidity Crunch
5. Trio of Executives ot First Data Departing, Including CFO
6. The 25 Most Powerful Women in Banking
7. Seldom-Heard Appraisals of Home Valuation Code
8. Joblessness Clouds Bank Sector's Turn
9. Financial Crimes are Getting More Sophisticated
10. FASB Mark-to-Market Plan Could Have a Seismic Impact

maker and currency data provider, my company believes all forex traders should be treated equally, with no conditions attached to volumes traded or account balances.

The concept of flash orders is not one that we support; all traders receive price updates as they occur, in real time. We publish short and long positions held by our customers, making it possible for all traders to gauge the depth of the market for a given currency pair. Hiding this information — or worse, providing it to select participants only — is simply indefensible.

The SEC should formalize its approach to the use of technology and the markets; following through on its commitment to ban flash orders and dark pools would be a logical starting point. It should then mandate the adoption of new technology to ensure all market participants are treated fairly.

Some have suggested that requiring all trades to be conducted via an exchange would lead to greater transparency, but this is suboptional. Besides, we have seen that exchange-based trading in itself is no guarantee of fairness. Alternatively, mandating the publication of each order entered and executed on an over-the-counter market would ensure true market efficiency in a cost-effective manner.

Legislating transparency is easy. Legislating fairness is not.

Michael Stumm is the chief executive of OANDA, an online currency trading firm.

More articles in Viewpoints Letters

WHITE PAPERS

- Reducing Costs and Increasing Profitability with Customer Communications
- Strengthening Governance, Risk, and Compliance in the Banking Industry
- The CARD Act – Move Ahead of the Curve
- Fraud Trends in 2010: Top Threats From a Growing Underground Economy
- Tapping Into Generation Y: Nine Ways Community Financial Institutions Can Use Technology to Capture Young Customers

WEB SEMINARS

Small Biz: An Avenue for Lending Growth
June 23, 2010

Meeting the Challenge: How to Implement Enterprise Risk Management
June 22, 2010

Can you keep a secret?
Available on Demand

Case Study: How a Leading Bank Provides the Ultimate Security for Customers
Available on Demand

Next Level Segmentation: Creating a Personalized Customer Experience
Available on Demand