‘The market is rigged’ – Michael Lewis

Kamal Ahmed writes in the *BBC*:

> In his seminal work on the role of high-frequency traders in global stock markets, Michael Lewis quotes Charlie Munger, Warren Buffett’s right hand man.
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> Mr Munger said that high-frequency trading was “the functional equivalent of letting a lot of rats into a granary”.
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> The central thesis of Flash Boys, which is published, with an updated final chapter, in paperback this week, is that electronic trading has rigged the market against ordinary investors, particularly in America.
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> Computer algorithms allow high-frequency trading (HFT) firms to “get ahead” of institutions investing on behalf of our pension funds and savings schemes.
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> Because HFT firms execute deals in tiny fractions of seconds they are able to “front run” human traders who are buying stocks and make a small “skim” on the deal by pushing prices up or down.
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> Although each “skim” is tiny, the overall effect, according to Mr Lewis, is that billions of dollars are being lost by investors to HFT firms which have inserted themselves into the market.
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> This, Mr Lewis says, is tantamount to rigging the market. When his original book came out last year Entertainment Weekly said: “If you own stock you need to read Flash Boys – and then call your broker.”

‘Unfair’

I caught up with Mr Lewis yesterday during his short visit to Britain from his home in California. He told me that what was happening in America was a threat to markets in Europe and Asia.

“It is inserting itself everywhere,” he said.

“High-frequency traders pay for an advanced look at [market] information so they are in an unfair position. They know the prices before the ordinary investors they are trading against.

“If you can trade at light speed, you can make thousands and thousands of trades in a second.

“It is offensive to me that you have essentially rich traders skimming off of middle class savers. Weaving that unfairness into the financial markets especially at a time when inequality is a problem seems crazy to me.”

‘Cosy club’

Mr Lewis says the major question is how to structure markets for stocks and shares as well as bonds and currencies as computers slowly and inexorably take over from human traders.

Martin Wheatley, the head of the markets watchdog the Financial Conduct Authority, has said that high-frequency trading now accounts for 30% of business on the UK equity market. In America it is higher.

Mr Lewis says that it is unclear – certainly in the US at least – whether the regulators are going to do anything about what he says is such a major problem.

One reason, he argues, is the “revolving door” between the

Wall Street banks and firms engaged in high-frequency trading and the regulators themselves. A "cosy club" has grown up, he says.

But, although that may be the case, Mr Lewis actually argues that the story of Flash Boys is one of hope.

And that's because the main witness in his book, Brad Katsuyama, a trader at the Royal Bank of Canada, has set up an exchange called IEX which seeks to eliminate "predatory opportunities created by speed".

Goldman Sachs, for example, has committed to IEX, and is the exchange's biggest source of orders.

"There is a path through the market [to a solution]," Mr Lewis told me. "The main characters in Flash Boys set out not only to expose the problem but to fix it.

"They built a market place that they think is a fair market place where investors meet on equal terms."

Of course, there are many people who disagree with Mr Lewis's thesis.

They argue that computer based trading has brought efficiency to the market and the creation of many more opportunities to execute trades, thereby increasing "liquidity" or the ability of the market to move investors' cash to the businesses that need it to expand.

Rebecca Healey, of the market expert Tabb Group, said in a blog last December: "Lewis did highlight the issue of predatory HFT activity [but] many participants have already addressed this issue and have adapted trading strategies and their use of technology in order to engage with HFT constructively.

"Automation delivers choice and fosters lower commissions – which benefit the end investor.

“The claims that the buy side have been ripped off for years may have held sway a decade ago, but I have sat in countless meetings with buy-side and sell-side firms and vendors – all working together to improve the market place.

“Here in Europe if you are not endeavouring to fix the problem, you are part of the problem.”

Mr Lewis is not convinced, saying that perverse incentives to make ever greater profits means that culture change in financial services is glacial, if happening at all.

“When the incentives are screwed up the behaviour is screwed up,” he said. “And it creates a culture where screwed up behaviour is normal, it is even praised because it increases profits.

“Unless you change the incentives, you won’t change anything else.”