The Flash Crash Culprit

By Bill Johnston

Here comes a twofold lesson for all investors whether of the type who with pursed lips tap out arcane ratios derived from ultra-sophisticated balance-sheet analysis and weigh their findings against plotted graphs of historic share prices or those that, blindfolded, stick a pin into the appropriate page of the Financial Times.

The first lesson is this. Buy some online software!

Fellow-investor Mr Sarao has been arrested by Scotland Yard's Extradition Unit. The US Department of Justice (DOJ) is seeking to extradite him to stand trial in Illinois, the home state of the Chicago Mercantile Exchange (CME), the biggest futures exchange in the US. He's charged with one count of so-called 'wire fraud', 10 counts of commodity fraud, 10 counts of commodities manipulation and one count of 'spoofing', a form of market manipulation that involves placing a futures order and swiftly withdrawing it before the order is fulfilled. If found guilty, he could be sentenced to up to 358 years in jail, roughly in line with a multiple murderer (Illinois abolished capital punishment in 2011).

The DOJ asserts that Mr Sarao used a modified off-the-shelf automated trading programme to manipulate the market for S&P 500 futures contracts over a 5-year period, making about $40 million profit in the process.

The allegation is that he was sending spoof orders to sell futures contracts in the US stockmarket. He would drive the price of the stock down then withdraw the sell orders, but the price would already have fallen. He would then buy the orders back and guarantee a profit for himself. According to the charge sheet, he did this thousands and thousands of times over many years. This is an amazing insight into the way computers have totally transformed the Investment scene

Of course $40 million isn't what it used to be, and the risk of spending 358 years in a US prison will put the frighteners on many, but still….

The second lesson concerns the deal that investors are getting, private investors in particular.

The DOJ goes on to say that Sarao's alleged manipulation contributed to a major drop in the US stock market on May 6, 2010 Remember what happed on 6 May 2010? That was the day of the event that has gone down in financial history as the Flash Crash. In the mayhem that ensued, the Dow Jones index lost 700 points in minutes, wiping around $0.8 trillion from the value of US shares. The price of blue-chip US shares such as General Electric and Accenture crashed momentarily to as low as one cent, resulting in thousands of trades being cancelled retrospectively. It's alleged that Sarao's market manipulation provoked other automated trading programmes to pick up his trades and hence the mayhem.

Bill Johnston
Editor

There is of course abundant evidence of manipulation of prices in favour of market makers, the most recent being on the very day on which this article is being drafted

Four US regulators and the FCA levied $5.7bn in fines directly for manipulating foreign exchange benchmarks. Additionally, UBS and Barclays were ordered to pay $263m to the Department of Justice because their activity violated agreements signed when the banks were fined for Libor rigging.

Barclays, RBS, Citigroup and JP Morgan also took the unprecedented step of pleading guilty to conspiring to fix prices, while UBS, which co-operated with the US investigation, pleaded guilty to a separate charge of wire fraud related to Libor.

Speaking personally, I mostly just accept such goings on as mere pinpricks given the conveniences which stock markets in particular and free markets in general provide. But I must admit that there is one thing which flicks me in the raw. It happened famously on 6th May but that is only the headline case; it inflicts regular damage on my finances and I am not disposed to swallow it automaticallly as a mere pinprick. And it is this.

I use the stop-loss system as a matter of prudence, for I cannot know everything and am prepared in effect tp pay a price for insurance. I know that this means that, say, prolonged selling pressure perhaps based on faulty judgements might strip a perfectly good stock from my portfolio. That is an acceptable risk if for no other reason than the seller might well have the better case.

What I do not like are savage downward spikes of short duration, with no published news of any kind to give an explanation, almost as though they were designed to flush me out. There is never any news afterwards either.
Am I paranoid? Does anyone else share this experience?

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