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Statement of the Shadow Financial Regulatory Committee on

Beating Bad Trades

September 23, 2013

Despite continual innovations in the ways that financial assets are traded, recent events highlight some remaining aspects of fragility in our trading system. One example is the occasional errors in executed trades and the ex post “busting” or “canceling” the execution of such trades due to “error.”

Recently, Goldman Sachs executed a large volume of option trades at prices substantially away from the price of prior trades. A faulty computer program caused these errors, and the trades were subsequently reversed in an exercise of discretion by the International Securities Exchange (ISE). The Flash Crash on May 6, 2010 is another example, where many trades were executed at prices that deviated substantially from the immediately preceding prices. The validity of these trades remained in doubt for a number of weeks, greatly fostering uncertainty in the market. Market authorities eventually canceled most of these trades, but only after a costly delay.

Such highly publicized events, even if they occur only occasionally, can undermine the public’s view of the integrity and fairness of the markets. There is also the possibility of economic harm. For example,

when a trade is canceled to the benefit of one party to the transaction, the party on the other side bears a loss of the same magnitude. This loss may be compounded if the other party has taken offsetting transactions that are not canceled. Thus, ambiguity about the validity of executions seriously complicates the ability of both sides of the transaction to hedge their risk exposures or to achieve the purposes of the original transaction. Furthermore, ambiguity interferes with the willingness of parties to "step up to the plate" and provide liquidity during episodes of great market or system stress.

The ex post possibility of trade cancellations does not promote the best interests of the marketplace or investors. A better approach to limiting trading errors is to establish an ex ante set of rules that would block a questionable trade before it occurs. Following the Flash Crash, equity platforms introduced procedures that were intended to prevent obvious errors from producing a trade.

These procedures would stop trades from occurring outside a band around a reference price, which during the trading day is the average price over the prior five minutes. In setting trading bands, a tradeoff exists between eliminating trading errors and letting prices adjust to new information. For this reason, it is important to allow an individual trader the option to trade outside these bands by so indicating and taking the consequences.

The Committee recognizes that there are potential concerns to be resolved in designing any trading bands. First, trading bands rely on a reference price and on setting an appropriate interval on either side. For less liquid instruments, the reference price can be stale and thereby stop otherwise valid trades. Second, complex interactions can occur between the trading bands on different financial instruments. A trader pursuing a trading strategy that involves the simultaneous execution of trades in two or more financial instruments could find that only some of the trades are executed. But as long as a trader has an option to waive the restrictions of such trading bands, these two concerns are considerably diminished. Third, any trading band reduces the informational efficiency of prices as it will slow any substantial adjustment of prices to new information. As the bands increase, there is a greater contribution to informational efficiency of the market, while the narrower the band the more it will act to block some trading errors.

Despite their effects on informational efficiency, the Shadow Financial Regulatory Committee recommends that trading bands should be specified in advance, and extended where possible to all financial instruments and across all trading platforms.