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Fat Fingers and Applying the F-Word

By Brian Loy, CFA, CFP
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Often I hear each financial crisis caused by a "perfect storm" of conditions or events. And the other night, The Daily Show's Jon Stewart got my attention with an interesting line *"…I'm beginning to think these are not perfect storms. I'm beginning to think these are regular storms and we have a _ _ _ _ _ _ boat."*

Certainly there are areas that need attention. Do you allow time for the "Invisible Hand" to self-correct, or the "Iron Hand" to force compliance? In this article, I'll address two controversial areas, and share some relevant insight.

The Flash Crash, which happened in 10 minutes on May 6, exposed structural flaws in our stock markets. While the exact causes are not yet known, you can likely toss the "fat finger" and Tom Clancy-like conspiracies theories aside. The stock market plummeting some 5.5% in 5 minutes, then rebounding 5% in another 1-1/2 suggest that a major technical glitch happened. Over 10,000 trades in over 236 securities were cancelled as "clearly erroneous" trades.

Some experts are pointing their fingers to (1) highly fragmented structure of exchanges, and (2) lighting speed of trading. Formerly, we had major exchanges with traders and specialists. But with technology advancements, new exchanges and electronic trading platforms have popped up. In 2003, the NYSE handled about 80% of the trades. Now they handle about 25%. The rest are on the NASDAQ, and electronic trading on ArcaEx, Direct Edge, BATS, and others; and trading time is measured in milliseconds. There are built in stabilizers – e.g. trading halts to help curb massive sell-offs – but they vary by exchange. With increased program trading by "quant" guys (quantitative trading strategies using algorithms), some experts are asking that we find better ways to 'slow down,' otherwise we have no one else to blame but ourselves.

To improve market stability and integrity, a joint committee of market participants, academics and regulators is discussing coordinated circuit breakers ("time outs") among all exchanges, as well as for specific stocks. And there's talk of requiring registration of large traders to monitor HFTs (high frequency traders).

Then there's the controversy over whether or not brokers (securities salespeople in brokerage firms, banks, insurance companies, etc.) should be held to the same fiduciary (the f-word) standard as investment advisors. The financial and insurance industries have fought pretty successfully, to date, to maintain the "broker-dealer exemption" (so brokers need not register as advisors, if advice is "solely incidental" to selling securities). A recent Rand study concluded that most consumers don't know the difference between registered representatives (who have a "suitability" standard of care – "know your client") and RIAs (registered investment advisors, who have a "fiduciary" duty – act in client's "best interest"). If you don't know the standard of care in a financial transaction, is there a greater potential for unexpected results?

I'm not here to throw down the gloves. I have some very trusted relationships with brokers because they are straight arrows. However, I strongly believe that those who call themselves advisors do adhere to fiduciary standards, and it's equally ok for reps not to become fiduciaries provided they disclose to their clients. And what if the people in Washington, who insist on regulating and making decisions for us, upheld their fiduciary duties to us… to act with the skill, care, diligence and good judgment of a professional? Maybe a better world.

When the seas are smooth and the winds fair, sailing is going to be terrific. However, when it gets rough, a ship's seaworthiness, captain and crew are tested. Let's take the time to prioritize what needs to be fixed, and get them done.