

STOCK MARKETS

Knight Capital gets backstop, regulators under pressure to stop ‘flash crashes’

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A group of investors agreed to rescue the brokerage responsible for last week’s short but dramatic turmoil in the U.S. stock market as pressure mounted on regulators to prevent future trading malfunctions.

Knight Capital Group Inc. received an emergency infusion of \$400-million (U.S.) from six firms, which will allow the company to survive the massive loss it suffered after one of its software programs ran amok.

Among the investor group is TD Ameritrade Holding Corp., which is contributing \$40-million.

Canada’s Toronto-Dominion Bank is TD Ameritrade’s largest shareholder and owns a 45-per-cent stake in the discount U.S. brokerage.

The agreement announced Monday caps a tense weekend during in which it wasn’t clear whether Knight, a major player in U.S. equity markets, would be able to stay in business.

Its troubles began on Aug. 1, when a software program began shovelling orders into the New York Stock Exchange, causing wild price swings in roughly 150 stocks for about half an hour, an eternity in trading time.

The episode has reignited the debate over the role of automated trading programs that operate at lightning-fast speeds and in huge volumes.

Whether through glitches or unanticipated consequences, such software problems have triggered a string of events to spook individual investors, most infamously the “Flash Crash” in May of 2010.

The Knight incident is a “call to action,” said Duncan Niederauer, chief executive of NYSE Euronext Inc. on Friday. “Speed is not always better,” he added. “Market structure has gotten incredibly complex. It’s virtually impossible to explain to a policy maker or an investor any more.”

U.S. regulators vowed to accelerate their efforts to avert a repeat of Wednesday’s events and took a tough line with Knight as it reeled under the weight of its error.

Hours after the trades, Knight chief executive Thomas Joyce called Mary Schapiro, the chairman of the U.S. Securities and Exchange Commission, as she vacationed in Maine, according to the Wall Street Journal. Mr. Joyce asked Ms. Schapiro to cancel many of the trades involved but she rejected the plea.

Saddled with billions of dollars worth of shares it never intended to buy, Knight unloaded the holdings for a loss of \$440-million – more than the company’s market value at the time – jeopardizing its survival.

“The SEC’s job, and this is hard for me to say, is not to save Knight Capital Group,” Mr. Joyce said in an interview on CNBC on Monday. “They did their job.”

Instead, two of Knight’s customers, one of its rivals, and three investment firms came together to ensure its viability. TD Ameritrade, for instance, has exclusive clearing deals with Knight for client transactions involving futures, foreign exchange and bonds. Knight is a “trusted, valued partner,” said a spokeswoman for TD Ameritrade in an e-mailed comment. TD Ameritrade will now have a 7-per-cent stake in Knight.

Of course, Knight’s rescue came at a steep cost to existing shareholders, who will own about a quarter of the company going forward.

For some long-time market watchers, Knight’s story underscores the perils of today’s highly complex, computer-driven trading environment. There are now more than forty venues in the U.S. for investors to buy and sell shares. Many cater to a breed of investor who prizes speed above all as part of a strategy to wrest profits from thousands of trades per minute.

“The dangers here to the market are just overwhelming,” said Michael Greenberger, a former market regulator and law professor at the University of Maryland. Trading programs are supposed to have fail-safe systems, he added. “If you’re going to have trouble turning it off in a half hour, there’s no telling how uncontrolled the situation might be.”

With high-speed trading a fixture of markets, some say the key is to institute effective controls. “We need seat belts, we need airbags, we need to keep drunken drivers off the road. And maybe better guardrails,” said Bernard Donefer, who teaches at Baruch College and New York University.

The recent incidents are “bad events for a whole bunch of reasons, but don’t expect that we are going to live in a fault-free world,” he said.

Some of the measures imposed after the “Flash Crash” helped limit the damage last Wednesday, as trading was halted in some of the affected stocks. New safeguards are slated to begin early next year. That’s when U.S. regulators will test a system in which the prices of stocks are only allowed to fluctuate within a certain band based on recent trading; if the limit is breached, trading in the stock will be suspended for five minutes.