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Rein in the cyber cowboys

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Last month, news outlets reported on what may be yet another example of high-speed trading run amok. It was reported that a computer "error" caused the price of oil to spike by a dollar on the New York Mercantile Exchange in a matter of seconds back in February. Whether this was truly an error or not, the fact is that high-speed computerised trading has caused tectonic shifts in the way market participants trade and invest.

But are these new types of high-frequency traders (HFTs) contributing to fundamental capital formation, risk management and price discovery functions, or are they "sideline" trading, on the edges of the real markets? There is a good argument to be made that "parasitical trading" does not truly contribute to fundamental market functions. While I am not saying all high-frequency trading is bad for markets, I think there is a great possibility that some of it is. There may be some cyber cowboys out there and they could be giving respectable traders a bad name.

It seems clear that without this breakneck-speed trading, where millions of orders can be executed in microseconds, the Flash Crash of May 6 would not have been so volatile. I do not rule out the possibility that HFTs may have sought profits from the Flash Crash by arbitraging market quote feed delays. We know there were delays that day caused by an overwhelmed system. We are finding out now whether anyone took advantage of that sluggish system, but we know they could have.

May 6 hit futures markets particularly hard. The interconnectedness of trading securities and futures makes it almost a given that when something goes awry in one market, it will affect others. These markets impact the prices consumers pay for everything from a loaf of bread to a carton of orange juice. That is why it is so important that our regulations are sound.

We as regulators must get a handle on overseeing high-frequency trading. We know we have serious problems when prices can change so much and so rapidly, and we have to find ways for the market to pause and "take a deep breath" when that starts to happen. For one thing, we do not always know who the HFTs are. In the US, high-speed traders must work with a registered broker but they themselves do not have to register with regulatory bodies. Regulators around the world have a responsibility to get ahead of the game in this area – otherwise, consumers will continue to pay the price for any problems caused by what may be harmful new trading technologies.

One idea is for regulators to look more routinely at orders in addition to final transactions. In other words, we would then be able to stop harmful trades before they occur. The company in the February example lost over a $1m in about two seconds. What is horrifying is the thought of such a company managing your 401(k) or other investment.

Troubling too is the prospect of what a series of glitches could do to the global economy. Billions of dollars were sucked out of the US economy on May 6. Fortunately, the markets gained most of the losses back just as quickly as the price plummet occurred. If it had happened earlier in the day, while European markets were open, it could have been worse.

Regulators have generally lacked the technological ability to keep up with high-frequency trading, and that has to change. We need a posse with fast horses to keep up with the cyber cowboys. If they are doing something wrong, we need to put a stop to it, and better technology will be a means to prove it when it happens. Better still, we should be able to prevent wrongdoing in the first place. The financial reform bill passed in the US this year goes a long way towards helping us keep up through its provisions for real-time reporting and the ability to pursue disruptive trading practices. The way the law was written before, it was nearly impossible to prove that market manipulation had occurred.

It is now our challenge and our responsibility to ensure that we get this right – Congress gave us the architectural plans, and the hammers and nails, and now we have to build the structure. Developing appropriate rules to regulate high-frequency trading will ultimately protect American consumers and ensure that our markets continue to serve their intended purposes.

The writer is a commissioner at the US Commodity Futures Trading Commission