

MONEY TALKS:

Beware The Gremlins In The Machine

By Michael Casey

NEW YORK (Dow Jones)--Remember the day-trading ads of a few years back, with T-shirt-wearing Regular Joes earning "Money up the Wazoo" - as one E*Trade spot put it - by beating stuffy-looking Wall Street suits at their own game. Their central pitch hinged on the theory that new computer technology was improving market transparency, leveling the information playing field and creating more wealth for more players.

So much for theory. Technology played a key role in the recent devastating crisis. That history serves a fair warning to regulators as they assess the latest technology boom on Wall Street: "flash order" electronic trading systems.

A decade before the crisis, while Wall Street's stockbrokers were losing commissions to online competitors, teams of computer programmers and mathematicians were fomenting a different revolution in those banks' fixed-income departments. They created collateralized debt obligations, stratified asset pools into which millions of mortgages were bundled and then sold to investors.

These instruments were heralded as a way to better manage default risk. Now, however, with the financial system weighed down by mountains of defaulted CDOs, it's obvious they were too complicated for outsiders to price. Here, technology had reduced transparency.

Yet the solution is not to crimp innovation, but rather to harness technology to empower those charged with protecting the market's proper functioning and ensuring information is shared equitably. Regulators and investors alike need greater access to the pricing models behind CDOs and other derivatives. Regulators also need new computer systems capable of interpreting the complex data - as do banks' internal auditors, who have also failed to keep up with the technology of their trading departments. Meanwhile, the seductive idea that technology will generate a more perfect market must be dispelled.

Without proper monitoring and regulation, innovation can distort the market as much as improve it. Whenever they've had a privileged position threatened - whether by new transparency-enhancing technology or by regulation - Wall Street banks have turned to innovation to create new monopolizing opportunities. Technology has let them regain control of information, that valuable commodity with which they generate "spread," or price margins.

Until the housing bubble imploded, that's what CDOs did for many banks. Similarly, the

development of mortgage-backed securities in the 1980s helped offset the Bloomberg machine's squeeze on bond price spreads. Later, as a push for exchange-based futures trading again threatened their middleman advantage, investment banks used high-tech models to develop over-the-counter derivatives, successfully lobbying to keep these free from Commodities and Futures Trading Commission oversight.

Often, however, as their enthusiasm for these new profit centers grew, the banks lost sight of the risk that was shifting from their trading floors to their back offices. "You had euphoria plus capacity, as the vast amount of new computer capacity - much of it decentralized - enabled independent trading desks to evolve and function away from the central nervous system of the firm," said Terry Connelly dean of the Ageno School of Business at Golden Gate University. Because "computers work so well much of the time," they create "an aura of rationality that reinforces the efficient-market hypothesis," said Connelly, who worked at Salomon Brothers when the firm employed both Lewis Ranieri, father of the MBS market, and Michael Bloomberg, inventor of the machine of the same name.

Yet at those crisis moments when the efficient market is exposed as a myth, the massive buildup of underregulated positions exacerbates systemic risk. The machines, or the models, go spectacularly wrong - as with the vicious cycle of selling induced by limit-down trading programs during the 1987 stock-market crash. These issues are coming to a head as Wall Street, again threatened by regulatory overhaul, seeks new competitive advantages via electronic trading platforms whose ultrafast trading capacity is unbeatable by human actors. It's the next step in the search for spread advantage, Connelly says - from price spread, to information spread, to time spread.

What makes these systems distorting is not their speed per se. It is the millisecond advance peek at prices that some exchanges provide to paying subscribers with the capacity to perform these "flash orders." This represents a buildup in technology-driven imbalances not unlike those that preceded past financial crises. The Securities and Exchange Commission wants these practices contained. Its goal should not be to kill the technology but to prevent those who own it from creating and exploiting such distortions.

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