Commentary: Two Decades and Four Flash Crashes

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Originally Published in *Traders Magazine* on October 19, 2010

http://www.tradersmagazine.com/news/sec-cftc-flash-crash-joint-analysis-106479-1.html

What a difference a couple of decades makes.

As widely reported, the joint analysis of the SEC and CFTC into the causes of the infamous "flash crash" that occurred in the afternoon of May 6, 2010, was published on September 30, 2010. It appears that Waddell & Reed, the investment adviser for a large mutual fund complex, launched a software program to sell 75,000 E-Mini contracts as a hedge to an existing equity position. The E-Mini is a futures contract based on the S&P 500 Index. The existing demand was not sufficient to absorb this sell order, causing the circuit breaker for the E-Mini on the Chicago Board of Trade to trip. Other automated traders reacted by selling SPYs, an ETF also based on the S&P 500 Index and then equities. The demand for these products was also not up to the selling pressure, and as various market participants reacted by withdrawing from the market, chaos ensued. However, the confusion was brief. Order was restored to the markets within about 30 minutes.

The flash crash provides context to Warren Buffet's characterization of derivatives as "instruments of mass financial destruction." And to quote that most famous of oracles, Yogi Berra, "it is déjà vu all over again."

On Monday, October 19, 1987, stock markets around the world crashed, with the Dow Jones Industrial Average dropping 22.61%. "Black Monday" remains the largest one-day percentage decline of the Dow Jones in stock market history.

The exact cause of Black Monday remains in dispute. "Portfolio insurance," a popular institutional strategy that involved heavy selling of S&P Index futures, was the leading culprit.

There is not much doubt about the cause of the "market break" of October 13, 1989, two years later. Two traders at Salomon Brothers sold large amounts of S&P 500 Index futures at a fragile time, resulting in a market collapse. Like the Waddell & Reed trader responsible for the flash crash, the Salomon Brothers traders denied evil intent. The SEC didn't buy it, and brought an enforcement action against them. It remains to be seen whether the SEC will bring a similar action against Waddell & Reed.

On October 27, 1997, the stock markets experienced the largest point drop in stock market history, although in percentage terms the drop was only the tenth largest. On that day, the 350-point Dow Jones circuit breaker was tripped, resulting in a 24 minute trading halt. When trading resumed at 3:00 pm, the market rapidly fell another 200 points, resulting in an early market close at 3:30 pm. It turns out that heavy selling of S&P 500 Index futures following the 3:00 pm reopen caused the ensuing collapse.

As is the case with prior crashes, there are all sorts of proposals for preventing the next market crash. The most popular proposal for the moment is to restore some version of the NYSE specialist, and in particular, the specialist's affirmative obligation to make a market when none would otherwise exist.

High frequency traders are not particularly popular at the moment. So, SEC Chairman Schapiro has suggested that, for the privilege of engaging in high frequency trading, perhaps they should have the obligation to provide liquidity during market crashes. Another similar idea is to require market makers to quote in a narrow band, effectively using their capital to stick a finger in the dyke.

The difficulty with affirmative obligations is that they just don't work. The NYSE specialist was alive and well in 1987, 1989 and 1997. When the market crashed, specialists stood aside and watched it plummet. This is completely understandable. Standing against a market crash is simply suicidal.

Similarly, the NASD tried all manner of narrow quoting bands for NASDAQ market makers in the late 1990s. None of them were even modestly feasible under ordinary market conditions. In times of market stress, the result would likely be mass SIPC liquidations of complying market makers on the morning after.

Each of modern history's spectacular market crashes spawned extensive regulatory inquiry and analysis with ponderous results published months later. They also inspired solemn pronouncements from regulators and politicians, who made optimistic forecasts that this sort of thing will never ever happen again.

My personal favorite was uttered by the current CEO of FINRA, Richard Ketchum, who was head of the SEC Division of Market Regulation (now Trading and Markets) in 1989. Speaking in March 1989 about Black Monday in 1987, Ketchum proclaimed: "Yes, institutions have learned from October 1987 and hopefully will never again throw their assets into programs calling for arithmetic liquidations of large percentages of the stock portfolios." No one knows more about the equity markets than Richard Ketchum. Yet, Ketchum's hopes were dashed a few months later during the market break of October 1989 and in every crash since then, including the recent flash crash.

Richard Ketchum was succeeded at the Division of Market Regulation by Brandon Becker, who made a somewhat different observation. "Derivatives," he said, "have been the culprits in every market crash in modern financial history."

I think it is possible to be more specific. S&P 500 Index futures have been the root cause of every market crash since 1987.

Brandon Becker's prescient remark brings to mind the child who points out that the emperor is wearing no clothes. Despite the obvious and proven danger to the markets and our national economy, I have yet to hear a single proposal to limit the use of S&P 500 Index futures.

This is not surprising. The S&P 500 Index future is the most popular and financially rewarding commodity that trades on the Chicago Board of Trade. ETFs based on the S&P 500 Index are certainly the most popular ETFs, and I would guess, the most popular securities traded in the National Market System (NMS). So, no one wants to impose any limits on their use, which would naturally curb industry profits.

But the fact is that S&P 500 Index futures are dangerous. No one ought to be able to place a sell order for the immediate execution of $4.1 billion of them.

Four market crashes are enough. It is time to put a leash on S&P 500 Index futures.