Predatory Market Making May Have Led to Crash
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On January 4th of this year, Rambus (RMBS) fell 30% in a matter of five minutes. It immediately bounced back and was later attributed to a trader with a “fat finger”. When this incident occurred, I discussed on Zero Hedge, the possibility of this being more than just a trader with a “fat finger”. (http://www.zerohedge.com/article/rambus-hft-fat-finger-precursor-things-come). I speculated that this could have been caused by a market structural problem. This could have been caused by a lack of liquidity due to predatory market making.

Today the same incident occurred, except this time, it happened in the overall market. Again, the media is blaming a trader with a fat finger. This may have been the catalyst but it was not the problem.

Predatory market making practices are driving liquidity providers out of the market. Algorithmic systems constantly step in front of displayed liquidity providers, and discourage them from placing passive limit orders. They are programmed to automatically step in front of displayed limit orders, to be at the front of the line for execution. This practice is especially prevalent in thinner stocks. If a human trader places an order at $20.05, the algorithmic system automatically bids $20.06. If the human raises their bid to $20.07, the computer goes to $20.08. This discourages true liquidity providers, and they place less passive limit orders.

Even in the 5 minutes that the market was crashing, these algorithmic systems were still abusing displayed orders. I placed a few buy orders during the crash, and my orders were still automatically stepped in front of by a penny. As my friend, Jason Fournier mentioned in his comments to the SEC, “not only are they discouraging liquidity, they are not allowing it.”

Broker-dealer internalization also abuses displayed liquidity as they continuously internalize retail order flow in front of displayed limit orders. In some cases they step in front of the order by as little as 1/100th of a penny, an abusive practice called sub-pennying.

Broker-dealers justify this practice by saying they were giving their customer price improvement. But they completely ignore the unquantifiable loss to the market participant who was displaying the order, and did not receive the fill.

These predatory market making practices are having a devastating effect on liquidity in our market. As true liquidity providers become more discouraged, and place less passive limit orders, the depth of the market gets thinner. Therefore, when we have a trader with a “fat finger” accidentally make a mistake, there are less liquidity providers to cushion the blow.

If these predatory market making practices are allowed to continue, eventually there will be no real liquidity in the depths of the market, and when there is a market impact event, we’re in big trouble. Today was just a taste of things to come.