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Kill switches may be too difficult to implement despite new call by CFTC member, expert says

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CFTC Commissioner Bart Chilton has called for high frequency traders, or "cheetahs" to face so-called kill switches that would shut down a broker dealer's trading over erroneous orders or technology glitches. But a trading expert said the measure may be too difficult to implement in practice.

The problem with kill switches lies with the timing of the decision to turn off electronic trading, said Bernard Donefer, a professor of Trading Technology and Risk management in financial markets at Baruch College and NYU Stern School of Business.

Despite kill-switches being installed at the New York York Exchange at the time of Knight Capital's trading loss, market makers failed to pull the trigger on the firm's trading, he said.

"None of them pulled the trigger because nobody could say this really was a problem," Donefer said. "These kill switches while they sound good, the implementation becomes very problematic in terms of when there is a problem no one wants to pull the trigger."

In a speech in Texas on Wednesday, Chilton, a Democratic commissioner, said kill switches should be compulsory for high frequency traders "in the event that cheetah programs go feral." He said the SEC and CFTC's efforts to create safeguards on electronic trading would help prevent a repeat of events such as Knight Capital's $440 million trading loss and the May 2010 Flash Crash.

High frequency trading, which allows traders to buy and sell stocks at microsecond speed using automated systems, has divided opinion between supporters who say it improves market liquidity and critics who say it destabilizes the financial markets.

Regulators are considering ways to regulate high frequency trading after a series of trading glitches roiled the financial markets over the last few years.

In September, the Securities and Exchange Commission held a roundtable with industry participants to discuss ways to promote stability in the markets. Some of the participants said errors from high frequency trading are inevitable because of the speed at which the trading is conducted. But Chilton said executives in high frequency trading firms should be accountable if their firms report false and misleading information.

"If there is another flash crash where people are damaged (they lose money) due to a rogue cheetah, I think there need to be steep consequences. And when I say consequences, I'm talking not just for the firm, but for individuals at the firm. If the cheetahs want to be involved in the high-flying, incomprehensible gambling world, okay, but if you cause harm to markets and consumers, we shouldn't stand for it," he said.

Chilton said in his speech that violations committed by high frequency traders should be penalized by the second.

"Under our statute, we can fine a miscreant $140,000 per violation ? and that used to be sufficient. That dollar figure made sense in yesterday's world of human-to-human trading. But it doesn't work in these markets," Chilton said.

"If you're making millions in seconds, then you should be liable for fines for bad conduct, counted in seconds," he said.

Senior executives should be held responsible for violations committed by their firms to restore the faith of investors in the markets, said Dennis Kelleher, president of the nonprofit financial-reform advocate Better Markets. He said regulators needed to impose stronger regulations against high frequency traders to prevent a meltdown in the markets.

Roy Smith, a professor at New York University Leonard N. Stern School of Business, said the existing securities and commodities laws provide legal standards for prosecuting executives who provide false and misleading information. The challenge is showing the executive's intent, he said.

"From regulators to class action lawsuits everybody is trying to establish that some bank or some broker dealer failed to disclose something," Smith said. "The fact is its very easy to say these things but its very hard to prove that somebody broke the law."

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