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Tackling antisocial financial behaviour

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First, Lord Turner, head of the UK's Financial Services Authority, put the cat among the pigeons by questioning the social utility of much financial innovation. Then Paul Volcker declared that the only financial innovation that had impressed him over the past 20 years was the automated teller machine. Yet, despite these reservations the world remains remarkably tolerant of anti-social behaviour in the markets and in the wider business environment.

Exhibit A is high-frequency trading. This type of computerised dealing exploits the millisecond gaps between news events and their impact on the markets. With the regulators sitting on their hands, such trading has expanded rapidly to the point where, on some estimates, it accounts for 60-70 per cent of the trading volume in US equities. Much of this volume is conducted by a very small number of companies.

A big reason for concern is that exchanges appear to have joined in an unholy alliance with this small group, which is allowed to see orders before the public. In effect, these people are privileged insiders who are profiting at the expense of those who are innocently saving for retirement and what have you.

Worse, the exchanges, which have a business interest in high volume, encourage co-location whereby traders can route their orders to servers in the same location as the exchanges' computer matching systems. Reducing geographical distance in this way cuts milliseconds off the time it takes for buy or sell messages to be sent into or back from an exchange.

This is all a form of front-running, even if the trading is not taking place in front of a client order. Proponents argue that anyone can co-locate, but genuine private investors cannot engage in this with an entry price measured in thousands of dollars. The supposed benefit is greater market liquidity. But the resulting market liquidity is far more than is needed for genuine investment. Why should a difference in the milliseconds be relevant to meeting pension liabilities with a 20-, 30- or 40-year duration? And, as the "flash crash" of May 6 showed, the activity can be highly disruptive.

Now that the regulators are taking an interest, they will probably focus on making the playing field more level. Far better would be to recognise that this competitive technological battle reduces social welfare in a similar way to an arms race. The fact that a handful of traders are creaming off big profits at the expense of genuine investors undermines the integrity of the market. A more draconian regulatory response would be appropriate.

Next, consider **BP** and the plans of the New York state pension fund and others to sue the company over the share price plunge. This will be damaging for the company. Yet the litigants' calculus is that the proceeds from successful litigation will exceed their share of the cost of the damage. The victims will be smaller shareholders who cannot play the legal game, along with other stakeholders including the employees.

Litigation is admittedly understandable in a US governance context. In the absence of majority voting, shareholders have much less ability to throw out underperforming directors than in Europe. Fierce lobbying by big business succeeded last month in removing a proposal to introduce majority voting from the Dodd-Frank financial reform bill.

But with a UK company such as BP shareholders are properly empowered. Not only is it easier for institutions to eject a dud chief executive. The UK's stewardship code is actively encouraging institutional shareholders to co-operate with companies. It would be better if the New York state pension fund engaged with the BP board on corporate strategy and risk management and sought to influence the composition of the board in a more constructive and responsible way.

On the topic of shareholder democracy, corporate governance and anti-social behaviour, I cannot do better than quote Michael Lewitt of Harch Capital Management on Dodd-Frank: "The financial reform bill that is emerging from Congress leaves so much essential work undone, and is so obviously a sell-out to special interests and expensive Wall Street lobbying efforts, that it can only be considered the latest example of all that is wrong with the American political system. In addition to leaving untouched the single biggest threat to financial stability – naked credit default swaps – it also fails to address the bleeding ulcers of **Fannie Mae** and **Freddie Mac**, ignores the deficiencies of the rating agencies and leaves most of the details of financial reform to be filled in by regulators, whose record in effectively doing their jobs is, to put it more politely than it deserves, pathetic."

Mr Lewitt was prescient about the financial crisis. For my money, he is also on the mark here.