May 6, 2010: A Market Odyssey

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Forty two years and one month to the day of the release of Stanley Kubrick's classic film *2001: A Space Odyssey,* the U.S. Markets fell precipitously for a period of time, followed by an equally impressive rebound.

The basis of Kubrick's film is that humans are baffled when a computer, HAL (which is driving a space mission), ceases to do human bidding and starts acting (and acting up) on its own. The reason: the computer believes that the mission cannot be left to human control and that it is better positioned to run things. Machine facilitation and human judgment are seen as one and the same. And therein lies an illustrative tale for U.S. markets.

The last decade has proven two things about the U.S. equity markets: first, they are amazingly adaptable and resilient; and second they sometimes adapt in ways that are not best for investors and issuers. This has never been more true since the start of the financial crisis.

The changes experienced over the course of the last decade in the equity markets have been cataclysmic and despite these changes the market has survived. Whether it has thrived (and whose interests are served by the current market structure) is an ongoing topic of fierce debate.

The questions of how the markets have come to this point and where market participants go from here are critical not only to current success but to the development of a market structure that can be sustained with some consistency over a long period of time, especially in a multi-asset global trading environment. So, stepping back to review the basics of how market structure has evolved and the legitimate roles of market participants will set a context for a discussion of where we go from here.

In 1975 the Congress mandated the development of a National Market System. Since that time, the Venn diagram of regulation, technology and competition has driven market structure. Over the course of the last 10 years regulatory changes to both rules and market structure have played an increased role in both what constitutes a market and how it operates. As regulators kept pace with technology changes the role of exchanges, broker-dealers, the types of instruments available for trading, and market operations all changed radically. These regulatory changes culminated most recently in Reg NMS which opened the floodgates to nearly 60 trading venues in U.S. equities. There will be yet again more changes as the SEC completes and implements ideas from its latest comprehensive review of the market structure. Beyond this review, the roll-out of *The Financial Reform Act* will reverberate for years to come.

On the technology side, electronic trading, the development of algorithms, the speed of communications and the ability to co-locate have changed the relationships between all market participants. For institutional investors, where an order is as it is traded, who owns information around an order and sponsored access have impacted performance, but also affect best execution requirements and fiduciary responsibility to end-investors.

On the competitive side, the roles of exchanges and brokers have begun to converge. Where exchanges once served as semi-public, member owned utilities (designed ideally to serve issuers and investors) they have, as commercial public entities, become competitors accountable to shareholders. So their decisions are to some extent driven, as are all corporations, by their quarterly reporting. This ownership change, combined with the move to electronics has created fierce competition between exchanges for listings and data revenue and between exchanges and all trading venues for trade execution.

There are numerous unintended consequences of the nexus of regulation, technology and competition. A focus on just two will highlight the problems in the current market.

There was a time when markets were designed to create a fair, liquid and orderly environment for transaction and this mandate was tied to the interests of issuers and investors. And though flawed, in the least, in price-driven auction market specialists were the liquidity of last resort and in order-driven dealer markets, market makers served this role.

Owing to a number of factors—Reg NMS, decimalization, the collapse of spreads, the speed of execution and collocation, the roles of specialists and market makers, for all intents and purposes, went away at the precise moment that they were needed most. This creates a liquidity vacuum when markets are stressed. The decline of human interaction in markets and the rise of the bulk of trading being machine based has led to the illusion that machines can and will exercise the same judgment as people will. Even as there is the continued recognition and evidence that markets are organic in nature. What happens when the machines take over and humans cannot control what occurs? May 6 was the first and likely not the last such event either in kind or duration.

Secondly, the rise of machine trading, low latency, co-location and the fallout from traders leaving bulge bracket firms has led to the HFT phenomenon. These traders, seeing market opportunity because of technology and regulatory environment, have developed millisecond technology that feeds off quotes and which has raised the quote to execution ratios to ridiculous proportions. At the same time these traders now account for both the number of trades and the volume in the lit markets.

One consequence of the HFT phenomenon is that traditional asset managers are reluctant to interact with such liquidity and have moved their own liquidity to dark pools, creating both liquidity and transparency problems, thereby having ripple effects on regulator's intentions for overall market structure.

Despite this, HFTs are wrapped in the flag of being the new market makers and liquidity providers. Nothing could be further from the truth. On May 6, the HFTs (and everyone else) withdrew liquidity. In effect, there was no liquidity of last resort on May 6. The exchanges had no mechanisms to protect investor or issuer interests. Further, trades done during that time were often deemed erroneous, though it has yet to be shown what these errors were or where the errors occurred. Certainly if a party was on the buy during the rapid decline, the assumption was the trade would stand.

Frequently, as in the case of short selling of financials in the summer of 2009, the case is made that markets should be allowed to operate. The SEC disregarded this position during the short selling in the financials and set out emergency rules. In the May 6 episode, market participants suddenly seemed to take a 180 degree turn and didn't want the market to operate. What they wanted was a do-over. When the market did operate as certain interests preferred trades were busted. What is needed is to get away from preference dictating these episodes and rapid reactions (such as circuit breakers) and move to a considered and consistent response. In other words, get back to the basics.

Many experienced traders have seen this HFT movie before in a difference guise. When the day trading phenomenon became popular, day traders were seen as liquidity providers and market saviors. The fact is these traders were often predatory momentum players with no long term interests. Leveraging off the well intentioned SOES mechanism, they in fact became known as SOES bandits. HFTs are akin to market jackals, scavenging off the legitimate strategies of longer term investors while simultaneously touting their importance to market health.

In the final analysis it does come down to whose interests are being served. Traditional asset managers, who represent the broad investing public, have shied away from lit markets, meaning there is less liquidity. It would be interesting to see what might have occurred on May 6 had the public markets been more liquid. Traditional block investors are driven to dark pools because their interests are not fairly represented in the very public markets mandated and regulated to represent those interests. Issuers are disadvantaged because there are no true market makers or specialists who at least nominally stand for their stocks (with implications for price discovery, market cap, and valuation). And forget retail investors, who are at the mercy of machines and predators.

What is required at this point is to get back to the basics: by default, the current regulatory environment and regime has led to the two key constituencies regulation is designed to protect being the least protected: issuers and investors.

As a first step, regulators need to fashion a regime that specifically restricts the ability to take advantage of market structure to disadvantage issuers and investors. If HFTs are the new market makers, then what must be required is that they fulfill the traditional specialist or market maker role as a regulatory responsibility — to assume risk and stand up for the issues in which they make markets.

Further, there must be a role for traditional asset managers to be incented to return to fair treatment in the markets precisely because they represent investor liquidity and interest.

2001: A Space Odyssey resolved its problem when Dave, the lead astronaut on the mission removes HAL's memory card, shutting down the machine and restoring human control. Perhaps the time has come for inserting the memory card of past market experience and get the true drivers of markets — investors and issuers — back to controlling market structure, with machines to facilitate, but not dictate where we are or where we are headed, simply because we have them. Because people can build quality machines, doesn't mean machines will ever build a quality market.

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