Instead of Protection and Price Controls, Let’s Try Competition

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The only thing actually disciplining exchange transaction and market data fees is SEC price-capping – not competition, argues PDQ CEO Donald Ross. But, he says, the industry doesn’t need lower price caps; it needs real competition. And we will only get that when the Order Protection Rule is repealed and exchanges are forced to compete for order flow on the basis of price and superior market structure.

It is a great irony that we in the inner sanctum of America’s free market, the stock-trading business, are once again warring over the need for more government price controls. The battlefield is exchange transaction and market-data fees, and the two warring camps have set up base on familiar terrain. The exchanges cry, “Spare us, for we are overregulated!” The users cry, “Fie! Ye be gougers!” Between them sits the wise SEC, which counsels more hearings and experimental rules to reveal the Truth.

Me, I am old and scarred enough to know that Truth never gets revealed in this way – not in the markets. Yet I am young and naïve enough to believe it worth my time to condemn the charade.

Let me start by addressing the humbug from the exchanges – so eloquently expressed by the honorable former congressman from New Jersey, and now executive director of the Equity Markets Association, Mike Ferguson. Writing in "The Hill," Ferguson explains that there is no need for price controls on his members because of the massive competition unleashed by the SEC’s 2006 “Reg NMS” market-structure regulation. There are now 13 exchanges, he tells us: 13! Plus dozens of “dark pools” subject to “lighter regulation.” With all this competition, how could exchanges possibly overcharge?

Mr. Ferguson must know that just three companies own 12 of these exchanges, so the notion that they are all competing against each other is ridiculous. But consider how we came to this strange state of affairs.

Consider that in July, the Intercontinental Exchange (ICE), owner of the New York Stock Exchange, bought out its comatose Chicago counterpart (CHX). On its surface, the takeover appeared to herald the inevitable and final technology-driven consolidation of the traditional U.S. exchange business. The Chicago Stock Exchange was the last of the so-called regionals to be swallowed up, like the Boston, Philadelphia, and Pacific exchanges before it, by one of the big conglomerates. Yet the takeover perpetuates a very different trend, driven by perversities in well-meaning but misguided regulation: fragmentation.

Since the 1970s, the SEC has had the integration of the U.S. equities markets as a primary mission – one imposed on it by Congress. It achieved this integration, on the surface, by mandating electronic linkages among exchanges. What it has done in practice, however, is to stop consolidation in its tracks. By providing legal protection to the best bid and offer on each exchange, a small and arbitrary part of their order books, it has kept their emaciated bodies on life support. Irrespective of the networking cost to the consumers of trading services, those trivial quotes cannot be ignored – they have to be treated as if they are unique liquidity pools that would not exist outside their brain-dead hosts. All of us in the markets know this is nonsense, and costly nonsense at that, but we have to play along for the greater good – meaning, of course, protecting the SEC from Congress.

Fast forward to the latest "consolidation" event and consider what actually is going on. ICE is believed to have paid about $70 million for CHX, or $50 million more than a Chinese conglomerate was willing to pay. And for what? For valuable technology? Intellectual property? Real estate? None of the above. It bought an exchange license, which is a legacy asset from the long bygone days when the Chicago Stock Exchange did something useful for the country – provide liquidity to investors in the Midwest. Now, it is a license to print money – or, more precisely, a license to extract money from prints.

Exchanges share in market-data revenue, not according to free commercial interchange but according to a formula – a formula as created by the guardian of our markets in Washington. This formula would be meaningless for a useless hulk like the CHX, except for the fact that its top-of-book is protected by the order-protection rule (OPR) in Reg NMS. Now in the hands of a much larger commercial enterprise which counts as its members firms that make money by exploiting regulation-induced microsecond lags in the transmission of orders and the dissemination of transaction information, the CHX license can be used to create new order types that will appeal to traders looking for a new way to trade profitably from yet another source of lag. It's all part of a bloated symbiotic ecology that keeps the U.S. stock market more fragmented than any in the world. And this at a time when technology has been driving consolidation of similar platforms in other product markets like social media (*think:* Facebook pushing out Myspace), as well as genuine innovation to produce new *differentiated* products (*think:* Snapchat).

Not surprisingly, given the free-riding opportunities afforded by the OPR to entities blessed with SEC "exchange" status, the only thing actually disciplining exchange transaction fees is Commission price-capping – not competition. The users, recognizing this fact, naturally demand lower caps. Though my sympathies are with the users, my faculty of reason is not. We don't need price caps; we need real competition. And we will only get that when the OPR is repealed and exchanges are forced to compete for order flow on the basis of price and superior market structure.

But, says Mr. Ferguson, what about all those "dark pools" leaching off the transparency and price discovery provided by his lobby's public-spirited member exchanges? Doesn't this show that the superior exchange market structure is being undermined by "lightly regulated" competitors that couldn't exist without it?

Surely it does not. Underlying this narrative is the assumption that showing prices at which traders will buy or sell does not affect the parameters of their orders, such as their size. In other words, if I am willing to buy 50,000 shares of a stock at $20 a share then there is no harm to me, and great benefit to the public, if I reveal that willingness on an exchange order book.

But any mutual- or pension-fund manager knows this narrative is false. This is important, because most of what Americans have invested in the stock market is managed by such funds.

If I, as a fund manager, display the fact that I want to buy 50,000 shares, the price of the stock will rise instantaneously – before I've bought a single share. Knowing this, I will need to deceive the market, telling it I only want 150 shares (the average exchange trade size).

A 150-share order is small enough that I may as well be a dentist, rather than a fund manager – an investor whose information and demand for shares is so constrained as to be almost irrelevant to their pricing. But having to pose as a dentist in order not to move prices against me is not costless. I must invest in technology that will allow me to trade 150 share lots over and over again until I've reached 50,000, all the while successfully posing as a dentist.

It should be clear that this "transparency" is not the same thing as true and complete information. Exchanges can mandate the former but not the latter. Until thought police can be installed in the markets, traders will see only what others choose to reveal.

Because of this fact, the prices at which trades take place in a "transparent" market are not what economists call equilibrium prices. Because I want 50,000 shares, but post only 150 as a feint, the trade price is – all else being equal – lower than the equilibrium price. The price I receive reflects my revealed demand; the equilibrium price, which is higher but which no one can see, reflects my actual demand, which I keep concealed.

In short, published trade prices are inaccurate representations of the actual market value of securities. And the source of the flaw is the structure of the stock market itself.

When continuous electronic trading platforms were first introduced in the 1980s, the transparency they brought to the market was widely seen as a great enhancer to efficient price discovery. This optimism was, however, unfounded. Security values routinely deviate from published trade prices.

Fortunately, however, the vastly greater computing power available today allows us to improve price discovery considerably. It is now possible to run auctions, on demand, with global participation, in which liquidity from all participants is concentrated in a single point in time. High-powered computerized auction platforms reward traders who input their true and complete demand, as no information is leaked to the marketplace that will move prices against them before execution – as it is in continuous markets. The elimination of information leakage, in turn, vastly improves price discovery because the larger trade sizes better reflect actual demand.

This dynamic of competition-driven innovation is another reason why I believe that free markets can solve problems that price controls have never solved – and will never solve. It is high time for the SEC, therefore, to stop arbitrating our self-interested pleading and to start letting us compete.