

13 January 2005

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Forthcoming Pensions & Investments

A NEW SEC MIND-SET

The SEC is designing rules for implementing its vision of electronically coordinated limit orders that “protect” investors by ensuring they receive the “best price.” The flawed assumptions in this mind-set are (1) the foremost important objective is to protect retail investors and (2) a more efficient market will result from restricting voluntary transactions, i.e., prohibiting institutions from trading at prices significantly different from the best quote (the trade-through rule).

A preferable mind-set would take into account that (1) the foremost goal of a stock market is to lower firms’ costs of equity capital and (2) all investors (retail and institutional) benefit from a reduction in restrictions that impede innovations customers have determined to be value-added.

Consider how firms’ equity costs of capital are affected by the trading costs of the dominant owners of these stocks — institutions and large retail investors. Investors’ demanded returns (costs of capital) from business firms include the costs of buying and selling stock. So, reduced trading costs for the dominant owners lead to lower costs of capital. This, in turn, yields higher stock valuations, higher capital spending, and faster economic growth. Joe Main Street’s costs for executing a market order for 100 shares do not materially affect firms’ costs of capital. Although the SEC’s goal of electronic integration of limit orders may well benefit these small investors, this implementation should not be at the cost of restricting large investors from trading in their own best interests.

Institutions are painfully aware that revealing their identity and order size to specialists and market-makers ensures poor execution. That is why they strive for fast execution and are willing to forego the so-called best price for a small number of shares in order to secure the best execution for their full order. Ideally, to reduce the transaction costs (including price impact) of their trades, they need to trade anonymously and directly with other institutions in order to eliminate information leakage to intermediaries.

It is informative to observe two radical innovations by entrepreneurial firms commercially successful in meeting the real needs of large investors. Put aside the SEC vision of an orderly national market in which all participants fully disclose their buy/sell intentions and think like an entrepreneur solely concerned with meeting *customer needs*.

Liquidnet's core innovation is to connect its trading platform to the order-management systems of institutions. The resulting network of real-time buy/sell indications enables traders to discover opportunities to find the other side for their large orders and negotiate while remaining anonymous.

With a change in a ticker symbol's color, Pipeline Trading Systems signals traders its system contains a large order near the current stock price. Neither the full size of the order nor whether it is a buy or sell is divulged. Front running is impossible, contrary to the NYSE auction process.

The benefits of these and other block trading innovations can be extended to retail investors. With large block trades that oftentimes occur at favorable prices *inside* the bid/ask spreads, there invariably is one side of the trade that has more stock to buy or sell. Such shortfalls could be addressed by retail order flow. This would be enormously beneficial for retail investors whose orders are sizable for thinly traded stocks having wide bid/ask spreads.

The brokerage establishment that profits from standing between buyers and sellers would surely try to block retail investors from participating in block trades at the leading edge of the innovation envelope. Removing such barriers should be a top priority for the SEC. A good starting point is to restore the freedom to trade by allowing institutions to opt out of *any* trade-through restriction.

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