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Give Small Investors an Alternative to Nasdaq

By Bartley J. Madden
And Ernest P. Welker

The Justice Department's highly publicized investigation into possible price fixing by members of the Nasdaq Stock Market has rightly cast a spotlight on how over-the-counter stocks are traded. Whether or not the Justice Department proves price fixing, the media coverage to date might lead reasonable people to believe this is evidence that "the market" does not effectively serve buyers and sellers without government oversight.

That would be an unwarranted and dangerous conclusion. Dangerous because, if used as a reason for greater government intervention, it would further hamper economic advancement. The market, in fact, has been quietly working for years to enable institutions to reduce transaction costs on stocks traded off the listed exchanges and thereby to force Nasdaq firms to do likewise or lose trading volume to new competitors. This has been good for institutional investors.

Retail Investors

What about ordinary retail investors? Progress for them has been slowed by — guess what? — government, specifically the Securities and Exchange Commission. We have here another case of one government body blocking the market from functioning, and another government body coming to rescue investors from an apparently inefficient market.

Institutional investors have been fleeing from the usual markups demanded by OTC market makers by increasingly trading OTC stocks on electronic trading systems, such as INSTINET. These off-Nasdaq systems enable professional money managers to find matching trades and transact directly with one another, eliminating the Nasdaq dealers and their excessive markups.

There is no alternative to Nasdaq for OTC retail investors. Is this because the huge spreads for those trades truly are needed? Expressed differently, the question is: If a profitable opportunity exists to compete with the Nasdaq monopoly for retail orders, why haven't entrepreneurs jumped at this opportunity? It's because they would be entering a costly regulatory black hole that might well consume their capital and postpone indefinitely the opportunity for retail investors to evaluate their product.

For monopoly profits to be maintained over time, the entrenched sellers must keep a unified position on pricing, and there must be barriers to the entry of would-be new sellers who would offer the product at lower prices. This describes the existing Nasdaq dealer network, which is loath to disturb its money machine. Retail OTC customers are to Nasdaq as lame zebras are to lions. Even major discount brokers such as Charles Schwab have their own Nasdaq dealer operations and earn sizable profits from this arrangement.

Major brokerage firms — and the government — assert that a heavily regulated "national market system" is the best way to "protect" small investors and that it is not in our "national interest" for electronic proprietary systems to take volume that might disrupt the established markets. In addition, Wall Street demands that the SEC be "fair" and regulate electronic systems in the same manner as established exchanges and dealer-controlled Nasdaq.

Those of us who are systematically ripped off by Nasdaq spreads are not impressed by these arguments.

As regards fairness, modern electronic matching systems link buyers and sellers directly. Because middlemen are eliminated, there is not much need for the type of surveillance appropriate for the New York Stock Exchange, the American Stock Exchange and Nasdaq. It is noteworthy that Wall Street trading abuses occur because of the opportunities for self-dealing by the inner club of middlemen who stand between buyers and sellers. If innovation can threaten to reduce the need for middlemen and to sharply lower investor costs, Wall Street's answer is to use a regulatory maze to block the innovation.

It is noteworthy that Wall Street trading abuses occur because of the opportunities for self-dealing by the middlemen who stand between buyers and sellers.

Steven Wunsch, a pioneer in securing "limited volume" approval to operate an electronic call auction for institutions, notes that proprietary systems are designed to serve the public directly and not to funnel orders through intermediary members. Regarding Wall Street's clamoring to require exchange registration for such trading systems, he says: "It would be as if the railroads had gotten Congress to block the airlines from competing with them unless they agreed to run their planes only on tracks on the ground. This, in the interest of fairness to the railroads."

Retail investors would not need Justice Department police actions for long if the SEC would provide a fast track for entrepreneurs to test electronic trading for retail OTC customers. This, in turn, would promote economic growth.

How does competition for Wall Street promote growth on Main Street? Start from a retail investor's perspective. How big are Nasdaq costs for him? One of the authors of this article recently bought a small ($50 million equity) Nasdaq company when the stock quote was 6½ bid by 7¼ ask. This means that a buyer must pay $7.25, but a seller receives only $6.50. If the stock were held for one year, and then sold when the quote is the same 6½ bid by 7¼ ask, $6.50 would be received. Hence, the investment would create a loss of 10%, even though the quoted stock price did not change. The Nasdaq dealers would make money, which is the fundamental purpose of a dealer-run market. But a trading system designed to benefit customers would facilitate trades so that buyers and sellers would receive the same price.

It's easy to see how a similar middleman arrangement would hamper business in, say, bank lending. Instead of borrowing at an expected 10% rate, businesses would be told that 20% is the cost of borrowed capital because of an extraordinarily large surcharge. Consequently, many firms would borrow less or nothing at all.

It works the same way in the stock market. Investors price stocks to achieve a satisfactory return after paying taxes

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and trading costs. High trading costs are a surcharge that lowers stock prices. This signals management that the cost of equity capital is higher, resulting in less expansion and hiring.

With new electronic ways to trade stocks, buyers and sellers who do not need immediate execution can avoid middleman markups. Widespread use of electronic trading in the OTC market would mean higher stock prices for small firms in particular. Instead of a buyer paying $10 and a seller receiving $9, new electronic trading systems enable buyer and seller to split the bid/ask spread and trade at $9.50. This strikes at the heart of the age-old Wall Street argument that large bid/ask spreads are needed for less liquid stocks.

Not Much Attention

Regrettably, the less liquid stocks that would benefit the most from eliminating Nasdaq's excessive markups have not yet received much attention. We submit this is because (a) individual investors are resigned to being helpless, since no alternative trading mechanisms exist for them; and (b) the managers of small companies are unaware of the higher stock prices that would result from radically reducing investors' trading costs.

But small trades can be "packaged" into more sizable volume via electronic auctions at periodic intervals. Hence, a genuine business opportunity seems to exist for electronic systems to centralize trading in illiquid stocks. To find out whether this opportunity can be realized, the SEC must free itself from those it is supposed to regulate and give the market a chance to function.

Clearly on the defensive, Nasdaq recently applied to the SEC to offer its new "N-Prove" service. Nasdaq suggests that this service would enable small limit orders to be executed at better prices than those offered by the market-maker spreads. N-Prove is an effort by the "foxes" to demonstrate that they truly care for the welfare of the "chickens." There is no acceptable substitute for competition in ensuring the welfare of investors.

Mr. Madden is a partner in HOLT Value Associates in Chicago, and Mr. Welker is director of qualified plans with Mahoney & Associates in Springfield, Mass.