

The Financial Economists Roundtable Statement

on

The Structure of Securities Markets

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The structure of U.S. securities markets is both a topic for technical specialists and a matter that affects in very practical ways all investors in their pocketbooks. The effectiveness and efficiency of securities markets in processing transactions in hundreds of millions of shares each day, at an annual cost of billions of dollars, deserves more attention from the financial press and the public than it customarily receives.

It should receive the attention of the new Chairman of the Securities and Exchange Commission (SEC), Harvey Pitt, as he sets his agenda. He will confront few issues of greater importance, but he will not be writing on a clean slate. For the last quarter century, the SEC has been pursuing the goal of a "national market system" (NMS), without a clear specification of what that might be. Based on the discussion at its annual meeting in July, 2001, the Financial Economists Roundtable (FER) adopted the following statement to help guide policy makers in their oversight of the nation's securities markets.

I

The general legal concept of a NMS stems from the Securities Acts Amendments of 1975, which in Section 11A directed the Commission to facilitate the establishment of a NMS but did not undertake to define it. That was left up to the SEC, having in mind the general goals of economically efficient execution of orders in the best market, fair competition among brokers, dealers and markets, and availability of information about quotations and transactions. The SEC has been moving by tentative steps ever since.

Early actions abolished fixed commission rates, a boon to all investors, and established a consolidated transaction reporting system. The SEC also established a consolidated quotation system for all exchanges and market-makers, but never resolved how "firm" a quotation was and how long it lasted. The SEC required exchanges to be linked through the Intermarket Trading System (ITS), which permitted market makers on one exchange to send orders to another exchange to achieve better execution. However, "best execution" of customer orders has proved elusive of precise definition. But the general objective of trying to achieve greater linkage of equity trading markets remained. As the SEC was seeking to link markets more tightly, new electronic communications networks (ECNs) arose to serve particular investor needs. Some, such as Instinet and POSIT, serve

institutional investors. Others, such as Island and Archipelago, serve individual investors. The result has been that markets have become more fragmented, not less so.

One school of thought believes that all the problems of fragmentation would be best solved by a single, fully integrated market, coordinated by a central computer and mandated by the SEC. Customer market orders would be gathered from all sources, matched and executed at the best price quoted anywhere. All limit orders would be entered and displayed in a central limit order book. Trades (except possibly large block orders) would be executed by a computer, following rules of strict price and time priority. The rationale for such a centralized system is that it guarantees the same prices for all investors, particularly for small retail customers, who do not now have the same access as institutional investors such as mutual funds or pension plans.

A second school of thought observes that fragmentation is a natural result of competition and innovation. As a variety of markets with different technologies and trading procedures compete for somewhat different groups of customers with different needs, the result is competing market centers—registered exchanges (such as NYSE and AMEX) with designated specialists; NASDAQ with competing dealers; third market dealers in listed securities; alternative trading systems (regulated as brokers) serving institutional investors or providing on-line trading to individual investors. This second school of thought views the multiplicity of markets as a sign of innovation and vibrant competition, not as a problem that requires regulatory intervention. Markets are, in fact, linked, albeit not completely, in various ways and degrees—for example, by information and by private order routing systems of brokers and markets.

How should these alternative views be evaluated from the standpoint of the public interest? It is not an easy question to answer. The central choice is between fully integrated markets, which will level the playing field among investors immediately but would impede future changes, and fragmented markets, which will permit greater competition and are likely to lead ultimately to more efficient markets. A number of factors are relevant in analyzing this choice. One is transparency of price and quote information. Securities markets are in large part markets for information, serving to evaluate companies and their management and to allocate capital to the most productive uses. A second is the degree of customer access to each market. A third is the extent of the broker's duty to the customer to obtain best execution. And whenever there are multiple goals or values, there will inevitably be trade-offs among them.

II

In considering those questions, the FER believes there are some principles and empirical constraints that should be kept in mind. To begin with, securities trades are not homogeneous, standardized products but combinations of a bundle of attributes. Trades differ in speed, market impact, and commission or spread cost, as well as in the price per share paid or received. All of these enter into "best execution."

Different customers value those attributes differently. Informed traders (those who believe they have an informational advantage) value anonymity, while retail customers or index fund managers, who are rebalancing portfolios, do not. Dealers incur less risk in transacting with uninformed traders, and can charge lower transaction fees or spreads. Informed traders are concerned with the market impact and speed of execution of their orders, matters that may be of less concern to other traders. Day traders may pay far greater attention to speed of execution than to its cost. Mutual fund complexes can, under SEC rules, trade among their fund portfolios, pricing off market trades or quotes but without incurring execution costs.

Given these varying customer needs and preferences, different trading systems are constantly being created to serve them. Some systems (such as Instinet) cater to institutional investors seeking to avoid incurring the full trading costs of brokers and exchanges. Other systems automate procedures for handling small orders.

But these alternative trading systems depend to varying degrees on prices derived from the primary markets, so information linkages across markets are important and desirable. Recognizing this, the SEC has mandated transparency—the immediate dissemination of trade prices and quantities as well as the quoted prices and quantities at which future transactions may take place. In a transparent market, investors can make informed decisions about where an order should be sent.

The SEC has ventured beyond transparency in mandating an intermarket trading system (ITS) for routing orders among the exchanges and the NASDAQ system. The purpose of better intermarket linkages is to enable orders to be routed to the market center where they will receive best execution. The downside is that it has tended to discourage new trading systems because of the difficulty of integrating them into the ITS structure.

Institutional investors can and do monitor the execution of their orders, and develop ways to bypass market centers that they view as not performing satisfactorily. So obtaining best execution is a greater concern for retail investors. Retail brokers have a legal obligation to ascertain the best market and transact in that market to get the customer as favorable a price as possible. The issue has been — exactly what does “best execution” mean in operational terms? Many market makers believe it requires only that they execute customer trades at the national-best-bid-and-offer (NBBO) price, as shown on their computer screens, and not an obligation to seek better offers. That in turn makes it important that the NBBO include all limit orders, so that retail customers obtain the best prices.

III

As the foregoing background discussion makes evident, we have a complicated market system and set of issues. After extended review, the FER arrived at certain conclusions and recommendations.

(1) The multiplicity of market centers currently observable has been criticized as "fragmented" and inefficient. Indeed it is fragmented, but it is not inefficient. Fragmentation is another term for the existence of competitors seeking particular customer clienteles, and like competition in general, it promotes both innovation and better prices for customers. In our view, such competition will produce greater efficiency and lower transaction costs than would come from a NMS in the sense of an SEC-mandated, single integrated market. Furthermore, market participants have themselves developed links among market centers.

(2) Transparency of the quotes and trades is a desirable attribute of markets. Transparency has two important benefits. First, it enhances competition because it allows consumers to compare prices. Second, it helps achieve best execution because customers can monitor brokers to determine whether they are sending orders to the best market. Consequently, it may be desirable to display more information about trading interest at, and outside, the NBBO.

(3) Linkages among the multiple market centers for quote information, order routing and settlement are definitely needed. But the market centers and vendors have incentives to develop them in accordance with customer specifications, and they are evolving. The FER believes that the precise form of linkages is best left to the market centers, in their quest for trading volume and liquidity. Linkage should not take the extreme form of requiring a central limit order book (CLOB). A mandated CLOB would constrain competition and innovation.

(4) Detailed specification of the duty of best execution, spelling out price priority or price improvement or trade-through requirements, is a highly technical subject. The FER does not believe it is in a position to conclude that a particular set of execution rules should be adopted, given the different needs and priorities of different traders. In its view, the SEC has followed the correct policy of enhancing disclosure, most recently by new rules on disclosure of execution quality by each market center. As the data on execution quality receive attention from intermediary firms and academics, the issues and proper balance may become clearer. But we would urge the SEC not to adopt at this point a specific best execution standard.

(5) In the very broadest sense, these issues raise the question of what should be the role of government regulators in the structure of securities markets. We commend the SEC for having acted prudently in addressing such a sweeping question in a field in which technology is rapidly changing. It has avoided a rigid NMS, and has made useful moves toward enhanced transparency and linkages. But we have one note of caution: the 1975 Act placed the SEC, at its own request, in the awkward position of having to approve the rules of self-regulatory organizations (for example, the NYSE or NASD) in advance. That places on the SEC the onerous and impossible responsibility for foreseeing how trading markets should evolve. A natural reaction to such a burden, particularly for complicated and contested issues, is too often to delay and to consider everything at inordinate length. The consequence is a drag on innovation and, in a global market, the possibility that trades move offshore. It would be preferable for the SEC to exercise its

oversight discretion ex post, by subsequently ordering repeal or modification of rules that prove abusive or anti-competitive.

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