Don’t Come In, The Water’s Boiling

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Of Frogs, Boiling Water, Market Structure and Trading

The Metaphorical Story of the Frog and the Boiling Water is illustrative of current market conditions and, more significantly, the position in which current market structure has placed market participants.

The tale is as follows:

If a frog jumps into a pot of boiling water, it will immediately recognize the situation as bad, and hop out. Conversely, if a frog is placed in a pot of cold water, and the temperature is gradually raised to boiling, the frog will not recognize the subtle temperature changes, will not hop out, and eventually will die.

The water and the pot are the current market structure. The frog at this point is virtually any market participant.

Just a brief review of the breadth and depth of difficulties show how gradually market structure has boiled over, and now it is virtually impossible to hop out:

- The decline in confidence in equity markets and an attendant decline in market volume
- The end of penny spreads and the effect on small and midcap trading
- The move to a maker-taker model, designed to advantage parties other than investors
- The move of exchanges from a semi-public utility membership model to for-profit
- The rise of HFTs and the attendant skittishness of institutions to participate in trading
- The fragmentation in market centers and trading venues
- Machine trading (for example, look at BATS' ability to offer its IPO)
- BATS' machine difficulties related to securing best price
- The demise of Knight Capital
- The 83% decline in profits for GETCO, once touted as the "new (but risk averse) market maker"
- The decline in traditional dealer activity, and their willingness to assume risk
- The problems NASDAQ experienced with the Facebook IPO
- A significant decline in IPOs, as companies moved to the PE and VC arenas for financing

Where We are Now And Participant Inertia

Over the course of the last several years, JonesTrading has issued a number of papers covering critical issues and offering perspectives, as have numerous other market participants. What seems to be lacking is the ability to generate a conversation on anything other than on an incremental basis, rather than looking at the entire market structure. And it is this incrementalism, and the passive acceptance of it, that slowly is increasing the water temperature without reaction from market participants. The last comprehensive analysis of U.S. Markets by the SEC was the Market 2000 Report, which was shelved by the Chairman Levitt when he took office.

The sense that inertia and incrementalism are the only approaches does not necessarily have to be the case. What may be required is a systemic review of market structure itself. The Order Handling Rules and the resultant fragmentation; the facile acceptance of HFTs as "the new market makers"; the pricing models and the effects of algos and non-human intervention in trading; circuit breakers; and a host of other issues—all need examination in the context of a larger market framework.

None of the above developments are likely to go away. But they do need to interlock for the benefit of markets and investors and they do need to be integrated and examined as a whole. The idea used to be that market participants each played an essential role in efficiency. What are the roles of each of these market participants and developments and are they benefitting or hurting markets and end investors? Folks who see no need for such an examination may be concerned that their particular answer, their role in contributing to markets, may not measure up.

There was a time when any one of these events and developments articulated above would have sent reverberations through FINRA, the SEC, listing exchanges, and the market at large. And simply because conditions are new, does not mean they are in any sense normal. Unless of course boiled frog is on the menu.

Taken together, these events and developments signal a fundamental shift away from fair, liquidity and orderly markets designed for investor interest as primary. And what or who has replaced the investor as the primary interest in the marketplace? That is the question. It is almost impossible to define what participant at this point is advantaged in the current market structure, or whose interest the market is fundamentally designed to serve, despite the lip service paid to investors. They have voted with their asset allocations.

As a result of the lack of definition in roles, conditions of near savagery apply as each participant tries to eke out advantage at the margins, based on their own incremental interest. Because there is no overarching framework and consensus for participation, participants are confused.

There was a time when there was general agreement that investor protection and interest was the basis for a successful market and market structure and participants generally agreed to use that as the basis for developing competitive models. And let's not be naïve—the competitive battle was fierce and participants consistently tried with exchanges, regulators, and legislators to promote their own interests, models, and view of the world. But there was a centralized consensus, defined roles, and agreement that markets be fair, liquid, and orderly.

But somewhere along the gradual raise in the temperature, the central consensus around which all participants coalesced unraveled—and the result is that a new central consensus has not formed. As the poet Yeats reminds us:

> The falcon cannot hear the falconer;
> Things fall apart; the centre cannot hold;
> Mere anarchy is loosed upon the world,
> The best lack all conviction, while the worst
> are full of passionate intensity.

What Can Be Done?

As a first step, a marketwide conversation.

The current problems have occurred because each separate change to the market was seen as an incremental rather than an industry wide development. But the net effect has been to render markets far less robust than they have been in the past.

Regulators look at each event as discreet rather than looking at the structure as a whole. So, wash trades by HFTs are looked at; the Knight difficulties are investigated; the BATS trades are examined; circuit breakers are installed at exchanges (with limits up and down); nickel spreads are considered. Other issues such as pricing models are not on the table. And investors? Really not in the equation at all—it's about advantages for insider players fighting to secure advantage over granular issues.

What is essential as a permanent approach to the situation is to look at the structure and context within which each of these events and developments is occurring. For example, there has been no broad conversation, concept release, or proposal relative to the effects of algorithmic trading or HFTs, or machine based trading in the context of an overall market structure.

Investors may have well backed away from the equity market because that market ceased to place them first. Perhaps what is required at this point is a reset: one which will take a look at the overall structure and pose the question: what would the markets look like if we reasserted investors and their interests as primary (and a failure to place investors first would not be acceptable)? Such a conversation, and such a standard could actually right the market structure.

There are two other alternatives. One is to have the market wide conversation, and decide that investors are not primary and their interests should not be served. That would then force a conversation to develop a new consensus as to whose interest should be first.

The second alternative is to not have the conversation and to allow the current "drift arbitrage" to define what will occur.

The consequences and the questions could not be more essential to the health of the U.S. equity markets, investors, market participants—and ultimately the health and viability of the U.S. economy.

Conclusion

Constructing a market is not easy. Drift arbitrage posing as serious conversation is. It does seem that over the last decade markets have slipped away from their historical roles—and that rather than discussing that development and its implications, market participants have accepted the boiling water as both inevitable and determinative.

Perhaps a broader, deeper and larger conversation will result in a critical appropriation of what is working, what needs adaptation and what needs to be jettisoned—keeping in mind that absent a focus on end-investors and their interests markets become meaningless.

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