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Tough and targeted rules will strengthen markets



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The “Flash Crash” of May 6th should serve as a warning to the securities industry. It is time for all market participants – exchanges, market makers, proprietary traders, retail and institutional investors – to support reasoned market reform.

Reliable, efficient capital markets are a vital tool for capital formation, the transfer of risk and economic growth. Modern electronic markets offer investors tangible benefits of lower costs, immediate trades, improved price transparency and tighter spreads. Reforms should be targeted to address weaknesses forcefully without undermining the progress of the past two decades. There are six key areas for improvement.

Transparency: efficient, fair markets are grounded in it yet only firms that choose to be broker dealers and trade under their own name are easily identified by regulators. The

Securities and Exchange Commission’s proposed large trader reporting system will provide regulators with transparency into the trading practices of all firms with

significant activity; it must be enacted and implemented rapidly.

Naked sponsored access – whereby firms directly gain access to the market under another firm’s name and licence – hinders regulators’ ability to understand who is trading, creating a host of risks. The SEC’s proposed rule banning this practice must be implemented promptly.

Technology: technology and regulation

‘Flash orders’ create the belief that markets benefit professional traders at the expense of retail investors

have contributed significantly to the success of the US capital markets for more than 200 years. To safeguard against market manipulation, regulators need surveillance tools and information so they can quickly reconstruct trading for any trading day. Creating an end-of-day, consolidated audit trail – capturing all trades and the identities of all traders on all markets – will enable regulators to monitor the markets for illegal activity that harms all investors.

Level playing field: “flash orders” – where exchanges show orders to certain traders before the public – discourage the visible display of public quotes and create the belief that markets benefit professional traders at the expense of retail investors. As early critics of this practice, we believe the SEC should immediately approve the pending rule banning flash orders in stock and options markets. Further, stock exchanges should be required to provide fair access to their “co-location” services, the modern day trading pits, and trading information.

Uniform rules: competition between markets is essential to encourage innovation that benefits investors. But rules designed to address extreme volatility or market dislocation are not the places to compete. These rules should apply to all markets equally. The recently implemented circuit breakers for stock markets – designed to prevent price distortions by slowing trading under certain circumstances – do not go far enough. Uniform measures must apply consistently across the futures, options and stock markets. While trading halts are good, hard limits on the amount of downward and upward price movements in a given timeframe are better. Currently, limits in the futures markets prevent price spikes but allow markets to remain open and trading to continue. Limits prevent “clearly erroneous trades” – trades occurring at prices far away from the current market. In the equity markets, these trades may or may not be cancelled, creating uncertainty for investors and

diminishing confidence that markets function properly.

Market maker obligations: regulators must address the role market makers should play in equity markets. Market maker obligations are designed to create two-sided markets to ensure that investors can buy or sell a security any time and at a competitive price. In return for the risks inherent in their obligations, historically market makers have received certain benefits. It is

important to the health of the markets that the obligations and benefits are balanced.

As one of the largest market makers, we support stronger rules for liquidity provision. To

qualify as a market maker, firms should meet four criteria: provide useful liquidity, provide relevant prices, risk their own capital and meet higher capital requirements based on their quoting obligations.

Two of these bear explanation. Useful liquidity means market makers should be at the best bid or offer for at least 10 per cent of the trading day to provide competitive prices for investors. Their prices must also be relevant to the public market price. That means stub quotes – market maker quotes that meet an exchange’s technical quoting requirements but are not related to the actual market – should be banned and a minimum quoting time inside circuit breakers required.

We must learn from the events of May 6 and promptly enact well-reasoned reform to protect the integrity of our markets.

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