Commentary: Flash Orders Yet Another Challenge to Market Structure

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In 1999, I attended a seminar where the latest order handling rules were the topic of the day. Dr. Susan Woodward, who was once my Economics Professor at UCLA, chaired the panel, which contained such luminaries as my former boss, Buzzy Geduld, Peter Jenkins and Holly Stark, both prominent portfolio managers, and the now infamous Bernie Madoff.

Peter Jenkins, representing the views of many institutional investors at that time, stated that under the new order handling rules, he would put his bid for 200,000 shares right into the NASDAQ montage, rendering market maker intervention superfluous. Buzzy's response was a classic: "He won't do it twice."

The current controversy over "flash orders" is just the latest episode in a long-running drama over institutional order flow.

It is in the nature of large orders that they tend to move markets. The fact that someone has 200,000 shares of something to sell causes the market to drop, even when there is no fundamental reason for the sale. Worse yet, a large order provides something of a floor or a ceiling for risk for small trades, which causes the large order to sit on the book unexecuted while everyone trades around it. For their part, institutions blame scalpers – fast "in-and-out" traders who are looking to profit by trading around large orders or buying from the institutional seller and rapidly selling to the institutional buyer. So, institutions look for "natural" buyers and sellers, because at least in theory, the natural buyer or seller provides the "true" market price and has nothing to gain from trading around an order. A sale to the natural cuts out the fast traders in the middle. Of course, the natural can only be found by advertising some interest, and if there is no natural, institutions are happy to sell to the fast traders if necessary to get the trade done.

As a result, institutional traders are caught between two conflicting desires. On the one hand, they want to see everyone else's order because that gives them an opportunity to "price the merchandise." On the other hand, they don't want to show anyone theirs because that might mean their order won't be executed or there would be a sale to fast traders at a marginally disadvantageous price.

Market makers around the world have attempted to appeal to institutional investors by offering to help them find the natural other side of their orders. As a result, many institutions have standing orders or indications of interest with trading desks operated by firms with a reputation for institutional order flow. When a firm receives an order from a customer that would be of interest to another customer, a trader will provide this information to the interested customer before exposing the order for execution in the public marketplace. This ubiquitous practice, sometimes described as "internalizing order flow," is what allows institutional trading desks to operate profitably and distinguish themselves from their competitors. Retail firms may also internalize order flow by trying to match customer orders before sending them into the public market, but that is necessarily a more limited endeavor.

A flash order, originally conceived by Direct Edge, is essentially a variation on the theme of internalizing order flow. The idea is that before an order is sent by an Exchange or ATS into the publicly displayed markets, if the customer requests, the order is displayed for micro-seconds to Exchange members or ATS customers. If the computer owned by a member of customer is set to accept an order at that price, then it is never displayed to the public.

While internalization of order flow is everywhere around us, flash orders have stirred a storm of controversy. Senator Charles Schumer, who like many members of Congress has taken something of a crash course in the workings of the financial services industry lately, has publicly threatened that if the SEC doesn't stop the practice, Congress will ban it in legislation. My guess is that "sunlight being the best of disinfectants," flash orders are about the go the way of the Dodo bird into extinction.

But having strained the gnat of flash orders out of the markets, that still leaves the camel of internalization to deal with.

The difficulty with internalization of all types is that it means that orders are picked over before the public has a chance to interact with them. Their status as leftovers also means that public prices are inferior to the prices obtained by the insiders who can obtain the benefit of the "internal" price.

Richard Grasso, during his tenure as CEO of the New York Stock Exchange, argued with some validity that all orders should be forced into one marketplace because only then can we be certain that everyone is getting the "best" price. If it's the only price, it has to be the best price. Of course, he thought that marketplace should be the New York Stock Exchange. For many years, members of the New York Stock Exchange were forbidden to trade listed stocks anywhere but the floor.

The problem with Mr. Grasso's argument is that requiring all stocks to be traded in one location transforms that location into a monopoly. When that location was the

New York Stock Exchange, it charged monopoly prices and lacked incentives to implement innovative technologies. Congress was so offended by the antics of the New York Stock Exchange during its heyday as a monopoly that it passed the Securities Acts Amendments of 1975, which ultimately led to the adoption of Regulation NMS. As a result, the market now is fragmented into 40 squabbling competitors, each of whom is trying to attract order flow away from the other. The flash order is part of this larger competitive struggle.

Since 1975, the SEC has tried valiantly to attract institutional orders back into the public marketplace. So far, every initiative has been a dismal failure. The most recent attempt, Regulation NMS, contains a trade-through rule, which is intended to provide an incentive for institutions to place their 200,000 share orders into the public montage. The result has been the creation of an industry of "dark pools," where institutions can derive the benefits of a public market without exposing their interest to a public audience. The flash order, and dark pools generally, are just the tip of the very large iceberg of internalized order flow, all of which is designed to indulge the preference of institutions that wish to avoid having their orders interact with the great unwashed public markets.

We could, of course, go back to the mandated approach favored by Mr. Grasso – prohibit orders in NMS stocks from being executed away from the public markets. However, this is not 1975. Now, there can be no assurance that Europe will not become the trading venue of choice for institutional orders. Europeans are much more comfortable with "two-tier" markets, having never completely abandoned the notion of social classes. In London, for example, there is a central limit order book for the masses, while institutional orders trade entirely upstairs.

The SEC has announced that it intends to take a hard look at dark pools. My prediction is that this examination will yield yet another attempt at market structure reform. The smart money will take odds against the SEC on this one. I've lived through decades of market structure reform, much of which has been intended to cause institutional orders to interact with the public markets. To this day, Buzzy's observation is still correct: Institutional traders will never place a large order in the public markets twice.

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