

Commentary: Putting Humpty Dumpty Back Together Again

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In 1996, Buzzy Geduld, a famous trader and my boss at the time, told me: "In five years, the market will have changed so much we won't recognize it." Observing my effort to comprehend the magnitude of this statement, he added: "I bet you think I just said something truly profound. But, it isn't. I could have made the same statement every day for the last thirty years I have been in this business, and it would have been true every time."

Looking back five years takes us back to 2004. It's a safe bet that most traders, as well as the rest of us who try to make a living in and around the financial services industry, would love to push the reset button and start all over again from there. This is a natural response to difficult economic conditions.

The desire to "return to normalcy," a campaign slogan that carried Warren Harding into the White House, is everywhere around us these days.

The current efforts to reinstitute the "tick test" for short sales provide one manifestation of the nostalgia for normalcy. However, they also demonstrate why a return to normalcy is a delusion.

The proposed tick test, which is really five proposals (modified uptick, uptick, circuit breaker with halt, circuit breaker with modified uptick, circuit breaker with uptick), is riddled with exceptions intended to allow the continued functioning of market structures that have arisen in the two-year interlude since the original uptick rule was abandoned. So, there are exceptions that will facilitate dark pools, VWAP orders and international arbitrage, in addition to the plethora of exceptions that already existed in 2007. It was largely because of the need to make so many exceptions to the original uptick rule that it was abandoned as hopeless in the first place. Many, many more exceptions will be required if it is ever again implemented.

It gets worse. Since the tick test was abandoned, Reg NMS has virtually eliminated floor-based trading in favor of electronic exchanges. However, the differing speeds of networks, which are measured in milliseconds, will make it next to impossible to determine whether or not any form of the tick test has been complied with in most heavily-traded issues.

The proposed rule, or should I say "five-plex," has received a multitude of comments, most of which simply and wistfully ask that the original uptick test be restored. My personal favorite is from a former trader in Chicago. He asks that the Commission, besides restoring the old tick test, also bring back 1/16 spreads (teenies), or at least nickels!

The trader's comment reminds me of an old story about Supreme Court Justice Oliver Wendell Holmes. At 90 years of age, he was strolling down Pennsylvania Avenue in Washington, DC with a friend, when a pretty girl passed. Holmes turned to look after her. Having done so, he sighed and said to his friend, "Ah, George, what wouldn't I give to be seventy-five again?"

When Buzzy told me the markets would be unrecognizable in 5 years, minimum spreads were an eighth. Those were the days.

The desire to restore past, happier times in the markets is not limited to equity traders or proponents of the uptick rule. The Fed continues its herculean effort to restore the securitization market through the TALF program. Even this week, the "Wall Street Journal" was all aglow with news that the TALF program had managed to raise a paltry \$10 billion in a recent offering by a bank that is heavily subsidized by the Fed and anxious to do its bidding.

I suspect the Fed's efforts to restore the securitization market to its former glory will fail. However, I also disagree with those who would have us return to the more simple financial services industry that existed in the '50s.

Anyone remember the "3-6-3 Rule?" Borrow money from depositors at 3%, loan money at 6% and be on the golf course at 3 pm. The Rule was a hallmark of the saving and loan industry and harkens back to a much simpler time.

The post-crisis financial services industry may be smaller. It will undoubtedly be subject to different regulation. Its employees may make less money, maybe a lot less money. But, it is a delusion to think it will be less complex. The 3-6-3 Rule is an artifact of financial history. Too much has changed to make its restoration possible.

The markets that emerge from the current financial crisis, once the US Treasury and the Fed have ceased intervening in them, will be different from the pre-crisis markets. Securitization may exist in some form, but it is a safe bet that it will not look like pre-crisis securitization. The uptick rule may emerge in some form, although that strikes me as unlikely. But, it will not be the same uptick rule that existed in 1938, when it was first created, or in 2007, when it was abandoned as unworkable. Restoring even teeny spreads? A fantasy.

Markets have changed in the interval of financial crisis. Those who participate in them in future periods will operate under different assumptions.

There is no reset button in the markets, not for 50 years, 5 years or even 2.

Is this conclusion profound? Not hardly. I haven't been around as long as Buzzy. But I could have made the same statement on every day of my life as a financial services attorney and been absolutely correct every time.

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