Commentary: Reconsidering the Role of the Equity Market Maker

By Stephen J Nelson; The Nelson Law Firm, LLC

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On November 6, 2010, each of the national stock exchanges instituted rules to abolish so-called "stub quotes" by equity market makers. These rules were one of several responses to the "flash crash" of May 6, 2010.

Equity market makers are required to publish "two-sided quotations," or quotations on the buy and sell side for each security in which they serve as market makers. In theory, these requirements ensure that a ready market will exist for each security traded on a national securities exchange. If there are insufficient market makers to fill this role for a particular equity security, it is traded over-the-counter, which generally means that it is traded through facilities maintained by Pink OTC Markets.

Of course, market makers are not in it to make sure there is a ready market. Instead, they are trying to make a profit by selling stock at a higher price than they paid for it. However, market makers are not investment managers. So, they do not make their money by research leading to a belief that a stock's prices will rise. Instead, quoted prices serve as an advertisement to other market participants who wish to buy or sell a stock. Market makers hope their quotations will induce investors with orders to buy or sell a stock to use their facilities.

Ideally, orders from investors wishing to buy would be matched perfectly with orders from investors wishing to sell at any particular time. In a competitive market, the dealer's profits would be roughly equal to commissions charged by agency brokers for similar work. In real life, market makers constantly struggle with imbalances – more orders on one side of the market than the other. If there were only one market maker, the surplus of orders on one side or the other would be resolved by raising or lowering the price of the stock. This was the role of the New York Stock Exchange specialist; only one specialist was assigned to any particular stock. A specialist faced with an imbalance of orders would simply raise prices until the imbalance went away.

We abandoned the specialist with the institution of Regulation NMS in 2007, adopting a market structure in which many market makers compete for investor orders. This resulted in much lower transaction costs, which is good for investors, but also meant that a market maker with an imbalance of orders has no idea whether market prices are rising or falling. A market maker that guesses wrong – resolving the imbalance in sell orders by buying them into inventory on the theory that market prices are rising – will suffer large losses if it turns out that another market maker has received a large amount of buy orders so that the overall market is flat or declining.

Market makers that survive for any length of time learn to avoid guesswork wherever possible. This means publishing quotes near the market when the market maker has an order in hand, and staying away from the market the rest of the time. So, if a market maker has an order to sell, but no orders to buy, its published buy quote will be close to the market or may make the market in the stock, while its published sell quote will be away from the market. (Stock that is purchased will be used to satisfy the sell order.) Any other strategy would be ruinous.

This fact of life meant that, prior to the new rule, market maker quotes on the side where the market maker had no orders generally were as far away from the market as any particular stock exchange's system would permit quotes to be made. Market makers had no intention of ever filling an order at those far away prices. They were far away so that no executions would ever occur at those prices.

As a result, when a large imbalance of sell orders was not absorbed by existing buy orders on May 6, 2010, market orders to sell interacted with these far away prices, dubbed in the financial press as "stub quotes," and much to everyone's surprise, were executed at ridiculously low prices. Soon thereafter, the exchanges cancelled these executions.

It is important to understand what the new rule will accomplish. The new rule will not mean that market maker quotes will better reflect market prices. It will not improve execution prices for investors. Rules cannot abolish or amend economic reality. Market makers that stay in business will still place quotes for which they do not have orders as far away as regulators will permit. The new rules will require quotes in active stocks to be within 8% of the National Best Bid or Offer (NBBO). Less active stocks may be quoted 20%, and thinly traded stocks, 30% away from the NBBO.

The design of this rule, it seems to me, is intended to work especially well for automated trading systems, where machines set prices, rather than humans. Computers do a much better job than human at maintaining pre-set differentials. Human traders may neglect to make the necessary adjustments and get caught from time to time with a large undesirable position.

What the new rule will do, and all it really can do, is ensure that if there is another flash crash, market orders will be executed closer to the market, which it is hoped will alleviate the need to cancel them. It is truly hard to argue that the resulting executions will accurately reflect true market prices or be fair to anyone.

The new rule may cause the last of the non-automated market makers, if there are any, to pack up their tents and find another line of business. In that respect, this is a continuation of the long line of market structure changes beginning in 1975, when Congress urged the SEC to eliminate the dealer in market transactions between investors. While it can be argued that Congress only had the national securities exchanges in mind in 1975, recent rules introducing limit and market order protection in the over the counter markets also have placed the OTC equity market maker on the endangered species list.

In prior articles (See "Trading Ahead in OTC Equity Securities, Round Two," February 2009), I have suggested that dealer market structures may be appropriate where stocks are thinly traded, like the over the counter markets. Eliminating the dealer may also eliminate all quotes in certain securities. We should consider whether or not this would be good policy before dispatching the market maker into extinction.