Commentary: The Human Element in Market Structure Changes

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Last week, the SEC issued its anxiously-awaited Concept Release on Equity Market Structure. Concept releases are not rule proposals. So, they sometimes receive little attention, causing the SEC to literally beg for comments. The SEC will not need to beg for comments here. I expect the SEC to receive hundreds of comments on this release in short order.

The SEC's stated goal in issuing the concept release is to determine whether regulations to improve the current equity market structure are needed. But, this concept release is really all about undisclosed trading interest, or as it is usually described in the financial press – dark liquidity.

The topic of dark liquidity has come up before in concept releases. The market fragmentation release in 1994 was a different way of exploring the same topic. Market fragmentation deals with trading interest that is not available to all market participants, non-disclosure being just one of the reasons why it may not be available.

The Equity Market Structure Concept Release should also be considered the granddaughter of the central limit order book (CLOB) proposal promulgated in 1976, over 30 years ago. The CLOB proposal, which has been a brooding omnipresence ever since its initial release, was also a concept release in that it made no specific rule proposals. It also represented a regulatory initiative intended to bring dark liquidity to light.

I expect to write more about the substance of the Equity Market Structure Concept Release in future articles. Here, I offer some reflections on the effects of market structure changes on the people that work in the financial services industry.

All regulations alter the competitive landscape. As a result, they produce winners and losers. Some businesses are less profitable after a new regulation is introduced, while others are more profitable. Some business models that may not have even been possible become viable in the new regulatory environment. While this is simply a characteristic of any law or regulation, market structure changes have profound effects on market participants.

A mere decade ago, thousands of people worked for businesses that held themselves out as NASDAQ market makers. Many of these people were traders earning fabulous incomes. But, there were also a fair number of support troops – compliance professionals, accountants, and mid-office and back office personnel. These people had enjoyed a decent living working for their firms for decades, and in some cases, second and third generations of employees could be found working in the industry.

Over that time, the industry made drastic changes, generally in response to changes in technology, and particularly computerized technology. But a combination of rule changes – the order handling rules, limit order protection and then the creation of SuperMontage – transformed the NASDAQ market maker from a business dependent on the skill of human traders into an enterprise of computers and algorithms. Humans were reduced to systems janitors, fixing errors, dealing with hiccups.

Much the same thing happened to the New York Stock Exchange in the wake of Regulation NMS only a few years ago. Overnight, the NYSE transformed from a hive of human activity into a computerized trading system competing with NASDAQ for electronic order flow.

It is, of course, incorrect to blame regulatory change for these developments in the business of market making. The changes in business models are attributable primarily to advances in technology, which have imposed dramatic and inexorable changes on human society ever since James Watt cranked up his steam engine two and one-half centuries ago.

Nonetheless, financial services are heavily regulated. The introduction of new technology requires modifications to existing regulations. The New York Stock Exchange successfully resisted these modifications for many years, which is why the change to that organization was so dramatic when it finally occurred. It is startling to realize, as the Concept Release points out, that only around 13% of stocks listed on the New York Stock Exchange actually trade through its facilities, as compared to 80% in 1996.

Dark pools and high frequency trading -- business models that simply did not exist a few years ago -- are now household words. Another group of businesses have arisen to support them. So, now we have sponsored access, a term that did not exist five years ago. In contrast, ECNs, which once inspired so much controversy, have all but gone the way of the dinosaur, and the few that are left are trying desperately to register as exchanges.

Businesses and business models are mere artifacts and exist only to serve the needs of human society. The New York Stock Exchange is a human institution and only worth preserving to the extent that it enhances our economic well-being. It follows that the only effects of these developments that is worth our concern is their impact on humans.

The human trader is on the endangered species list. Many of them no longer work in the industry. The traders fortunate enough to find positions generally are happy to earn fractions of their previous incomes. There are pockets of human traders in places like the OTC markets, but even they are being replaced by computerized systems. I believe in a few short years, we will have to explain to our children what an equity trader was, much the same as history teachers tell us about iron puddlers or the firemen the stoked the boilers on railroad locomotives.

The trader's support troops, meanwhile, are scattered to the four winds. It has been much more difficult for them.

I am not a Luddite, opposed to new technology like the famous 19th Century English textile workers who destroyed mechanized looms in an effort to save their livelihood. But, this is a time when the job market is front and center in our democracy. It would seem appropriate to shed a little ink in support of the many displaced traders and those people who worked with them.

Our democratic society does a lousy job of finding something to occupy the people who get displaced by new technology. That is unfortunate. Workers who know they will be displaced, whether they are floor traders or textile workers, resist new technology because of the suffering it will cause them. A lifetime of useful skills, some of which are still relevant, is wasted, making us all a little worse off. This is bad social policy.

If the changes in technology are really useful to the economy of the United States as a whole, then it seems self-evident that part of these benefits should be used to retrain or rehire those that are displaced by it. A job, even one that pays less, is better than no job at all.

What I would like to see in concept releases is some recognition of the human sacrifices that may be required to implement new technology. And, perhaps the SEC could request comment on the numbers and types of workers that will be displaced by the regulatory change and what can be usefully done to relocate them. And, perhaps some discussion of the costs of these relocation efforts.

Humanity is not currently required in SEC rule-making. Until it is, every market structure concept release will be met with trepidation by market participants.

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