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Preparing for 'the big one'

Having lurched from flash crash to hash crash over the last three years, is the US equities market structure sound enough for the coming correction?

Rob Daly

When Belfast locals discuss the city's relationship with the doomed RMS Titanic, they often joke: "She was fine when she left here."

The 882-foot ocean liner was a design marvel of its day. Only its sister ship, the RMS Olympic, matched its size, complexity and innovation. On paper, everything about the ship appeared fine. It was only after the ship's infamous rendezvous with an iceberg on April 15, 1912, that the ship's passengers, crew and builder had cause to think differently.

Just over 100 years later, not everyone shares the same sense of happy optimism about the US equities markets. For many, there is a foreboding that a major market correction is lurking just beyond the horizon.

Since the end of November 2012, the US equities market has been on a bull run. But some spy a major disconnect between stocks and their fundamentals.

"The velocity of money in the market has not changed much in recent years, but the quantity of the money sitting on the sidelines has changed enormously," says Niall O'Malley, portfolio manager at Blue Point Investment Management. "Although central banks can print more currency, they cannot print more real assets, which equities represent."

As long as the US Federal Reserve continues its quantitative easing policies, investors will be forced to continue seeking investment returns from the equities markets instead of the credit markets.

Returning to 'normal'

The greatest concern for many is how the markets will handle the end of quantitative easing and return to 'normal' market conditions.

"I hope it does not create disorderly price actions that damage investor confidence," says O'Malley.

According to Larry Tabb, founder and CEO of the TABB Group, it all depends on how deftly the central bankers can let the air out of the quantitative-easing balloon.

"If they can let the air out slowly and allow the markets to adjust to a non-quantitative easing environment, trading volumes will continue to drift down for the next six to 12 months and be followed by a pick-up," he estimates. "If there's a problematic exit from quantitative easing, trading volumes will pick up much quicker."

Tabb believes that post-quantitative easing equity trading volumes could spike to levels witnessed during the credit crisis, flash crash and sovereign debt debacle. "There were sizable trading volumes, but I'm not sure if they were good volumes," he says.

To heighten concerns further, few sell-side traders or heads of desks have not experienced such a potential market correction, adds Matt Samelson, principal at industry research firm Woodbine Associates.

"Most people managing sell-side offerings came up in the 1990s and 2000s, when volumes were increasing and the buy-side was more forgiving," he adds.

Most traders who lived through 1987's 'Black Monday', in which the Dow Jones Industrial Average (DJIA) fell 508 points – or approximately 23% – in a single trading day, have moved away from the trading desk or retired, potentially robbing today's markets of a valuable perspective.

Faith in the system

The most important factor for a market to survive any potential crisis is the investor's belief that it operates in a fair and orderly way. Over the past few years, investor confidence in the US equities market has been challenged with alarming regularity.

With the benefit of hindsight, the US Securities and Exchange Commission (SEC) could not have chosen a worse time than 2007 to launch its market structure reform under Regulation NMS, a year before the collapse of Bear Stearns and Lehman Brothers.

Ill-timed timed or not, the new regulation sought to reduce trading costs by increasing competition among the exchanges, standardising trade increments and reallocating consolidated tape revenue among exchanges.

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The new market structure achieved much of what the regulators desired, according to Paul Daley, head of product development at technology provider SunGard's Fox River Execution Solutions unit. "Before we started this, we had the lowest trading costs in the world. Now they are even lower, but this does not make it a perfect system," he adds

As with any new environment, the new market structure comes with its own sets of growing pains, such as increased complexity, unintended consequences and new opportunities for market abuse.

None of this should have come as a surprise, says Woodbine's Samelson. "Many believe that the SEC is supposed to dictate frame-out optimal market structure and implement rules that have no unintended consequences. That's never been the case. The regulators work with industry to achieve stated ends, which means a lot of zigzags along the way."

"The SEC has done a respectable job of regulating the market," agrees Blue Point's O'Malley. "But the technology has gotten out in front of it."

Stem to stern

The great question facing the SEC was whether to address these issues holistically or with spot solutions. The regulator originally opted for the former, but retreated to the latter as other developments quickly took precedent.

The SEC issued a concept release to review Regulation NMS from stem to stern in January 2010. The release generated a great number of industry responses in the ensuing months. However, once the US Congress drafted and President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law in July 2010, the SEC put a holistic market structure review on the back burner.

While the SEC began working on the 76 Dodd-Frank rules for which it is responsible, the equities market experienced flash crashes, bungled initial public offerings and algorithms gone wild, not to mention the contentious rise of high-frequency trading. Most recently, the market suffered an embarrassing mini-crash in April when a tweet from a hacked Associated Press Twitter account caused a short-lived 145-point decline in the Dow Jones Industrial Average, the brevity of which indicated robustness not frailty.

The SEC, working with the industry, developed a series of solutions to address these issues and reduce systemic risk that they posed to the equities market.

First came the single-name circuit-breaker pilot after the May 6, 2010 flash crash, which was followed by a market-wide circuit breaker system and, finally, the current limit-up/limit-down measures to mitigate undo market volatility.

Similarly, the regulator introduced Rule 15c3-5, which requires any broker that provides direct market access to clients to route the client's orders through a pre-trade risk check before sending the orders to the market.

Most of these solutions address the symptoms, but not their root causes, according to Fox River's Daley.

"Rather than address an outdated concept for today's market like stop-loss orders, the regulators decided to install circuit breakers and limit-up/limit-down controls," he explains. "It is a practical approach since it likely is a waste of time trying to get people to stop using stop-loss orders."

Such focus on microstructure issues, have some wondering if it is time to re-examine the current market structure and start fresh.

For Tabb, author of a recent report, 'Regulation NMS Part I: Loved or Loathed and Why Many Want it to Die', such an idea is a non-starter. "It would be dangerous to start redesigning the US equity market from a blank sheet of paper," he warns. "All of the market rules and systems would need to change at once. Attempting to engineer something like this would be problematic at best."

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Nevertheless, at a New York roundtable event in May, SEC commissioner Daniel Gallagher said Mary Jo White, the watchdog's CEO, had backed a broad initiative to review the US equity market.

Call the coastguard

Instead of focusing on further reductions in trading costs, regulators should simplify the complex market structure to reduce systemic risk, suggests Jeff Bell, executive vice president and head of clearing and technology group at Wedbush Securities.

One idea that Bell has been proposing to the industry over the past few years is the adoption of an independent market-wide post-trade risk management platform that would examine an aggregate view of all a broker's trades to see if they are leading to risks that could not be detected by examining each order individually.

Bell envisions such a platform operating outside the walls of individual brokers, somewhat like the current industry discussion on exchange-based, pre-trade kill switches.

However, he believes it would be better to locate the post-trade risk platform at the National Securities Clearing Corp., the Depository Trust & Clearing Corporation's subsidiary responsible for post-trade services for most broker-to-broker trades.

FIGURE 1: REGULATION NMS: AN UNSTABLE INFLUENCE?

05-Mar-07	The SEC begins a phased retirement of the Intermarket Trading System as part of its market structure update under Regulation NMS
16-Mar-08	J.P. Morgan purchases Bear Stearns for $2 per share, which is changed to $10 per share two weeks later
15-Sep-08	Lehman Brothers files for bankruptcy
14-Jan-10	The SEC publishes a concept release calling for a broad review of the US equity market structure
19-Jan-10	The SEC proposes Rule 15c3-5, which would require all broker-dealers offering direct market access to have pre-trade risk controls in place
14-Apr-10	The SEC proposes the establishment of a large trader reporting system as measured by volume or market value
14-Apr-10	The SEC proposes the creation of a consolidated audit trail
06-May-10	The Dow Jones Industrial Average (DJIA) experienced an unexplained 1,000-point, or 9%, drop and recovery in a matter of minutes
10-Jun-10	The SEC approves a market-wide stock-by-stock circuit-breaker pilot that will last until 10 December 2010 for components of the S&P 500 Index
02-Jul-10	The SEC proposes the elimination of 'flash orders', which hold an exchange's best quote on the exchange before disseminating to the public
21-Jul-10	President Obama signs the Dodd-Frank Wall Street Reform and Consumer Protection Act into law. The SEC is responsible for developing and finalising 76 of the 237 new rules required by the Act
06-Sep-10	The SEC and US Commodity Futures Trading Commission publish their findings regarding the market events of 6 May, 2010
10-Sep-10	The SEC expands circuit-breaker pilot to include components of the Russell 1000 Index and certain ETFs
05-Apr-11	The SEC and the Financial Industry Regulatory Authority propose the establishment of a limit-up/limit-down mechanism to replace the market-wide circuit breaker pilot
14-Jul-11	Pre-trade risk Rule 15c3-5 goes into full effect
23-Apr-12	BATS Global Markets pulls its initial public offering after a software bug caused trading issues
18-May-12	Technology issues at Nasdaq OMX caused number of orders for Facebook's IPO to be entered incorrectly
18-Jul-12	The SEC instructs exchanges to deliver a plan to create, implement and consolidate audit trail by 1 October, 2012
01-Aug-12	Knight Capital Group loses $440 million in trades due to a run away trading algorithm
02-Oct-12	The SEC holds a technology roundtable with industry participants to discuss how to promote market stability. The conversation quickly turns to exchange-based kill switches
24-Apr-13	The DJIA experiences a momentary 140-point plunge and recovery attributed to a false report of an attack on the White House by a hacked Associated Press Twitter account
28-Apr-13	The use of market-wide limit-up/limit-down mechanism goes into effect
29-May-13	Nasdaq OMX agreed to a $10 million penalty over the Facebook IPO

Source: various

Placing the platform at exchanges would pose too many problem in terms of standardisation, according to Bell. "Each exchange offers different pre-trade risk controls. They're not standard and do not calculate risk in the same way as well as having different latency effects on their system."

Bell is also worried that exchange might view various risk-management checks as a source of competitive advantage. "Risk management shouldn't be a race to zero," he says. "There should be a clear set of expectations and rules to which people adhere rather than establishing a rule that allows 40 different market centers and 2,000 broker-dealers to implement their own interpretation of the rule."

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> *Niall O'Malley, portfolio manager, Blue Point Investment Management*

The suggestion is not without precedent. The US government introduced similar systemic risk mitigation regulations after the sinking of the Titanic with the enactment of the Radio Act of 1912. The act required all passenger liners to maintain radio operations around the clock as well as remaining in contact with other local ships and costal radio stations. For regulators, the challenge remains to prevent future disasters, rather than just those that have already taken place.