FT.com
FINANCIAL TIMES

Exchanges are coming close to the edge

By Michael Gordon
Published: June 7 2010 16:40 | Last updated: June 7 2010 16:40

In the early 1970s, a genre of rock music developed in a way that at the time was seen as progressive. Progressive or “Prog” rock bands took rock music in an esoteric and obscure direction. Aided by technology, band members deployed their skills and talent in ever more technically difficult and intricate applications. The fans stood and listened in wonder and adoration at what was happening either on stage or on their turntables.

Yet, as prog rock developed further the music became more technical and introspective. The fans got left behind. Today, there are parallels with the workings of our equity markets.

Equity market gyrations of recent weeks have become a hot topic for both regulators and participants. With some questioning whether the markets are currently fit for purpose it maybe useful to step back and remind ourselves of the primary purpose of the equity market.

Equity is the preferred vehicle for long tem company financing. Its lack of a term distinguishes it from debt, which is finite and so better suited to shorter term financing needs. Public equity markets exist so that owners can realise their investments and new owners can be found. In theory, equity owners are medium to long term in nature, thus matching the nature of equity itself. To better enable or facilitate the trade in equity on a day-to-day basis, firms with no genuine interest in the long-term success of the companies whose equity they trade are allowed in the market. They seek to profit from doing so, as a reward for the capital they allocate. That is entirely reasonable.

But the ability of the equity exchanges to facilitate these other players more effectively has led to the activity on the equity markets to be dominated by them. Aided by advances in technology, their dominance is starting to cause long-term users to doubt whether markets are becoming less effective.

One example is the growth of high frequency trading. In the US, it has left the market often hostage to the consequences of behaviours that have little to do with the underlying long, medium or short term economic realities of stocks. This is so because as much as 70 per cent of the share trading volume on the US exchanges is now high frequency. The exchanges are happy because a new revenue line has emerged.

However, this trend threatens to take the exchanges away from their original purpose. And when that happens, the markets risk ceasing to provide the core function for which they are designed. As with prog rock, the real fans are being sidelined.

Regulators are examining trading activity of May 6th that led to some stocks briefly losing 99 per cent of their value. As many as 10,000 trades from the mad 20 minutes on that day have been cancelled. Whilst no laws or rules may have been broken, it is clear that the activity that caused such chaos is undermining market confidence.

Exchanges are driven by revenue, understandably. They get tape revenue and also significantly increasing "co-location" fees. Co-location occurs as a result of the nature of high frequency traders. Their trading algorithms rely on such extreme high-speed information that they co-locate their servers under the same roof as the order matching engines – those of the exchanges. In today's world, a distance of 100 miles or so is a major technological disadvantage.

The exchanges have courted high frequency activity and the revenue it brings. But such activity has well and truly overtaken the more normal activity of the market. And so, questions of purpose need to be asked. "Do we really want a "Prog" equity market?

Equity is not a ticker, much as it was never a code or a piece of paper. It is a right of ownership that provides a rent, or return for the provision of capital. A ticket to a rock concert is right to a good night out. In the 1970s, when the bands turned inwards, the fans turned away. Exchanges beware. You are close to the edge.

Michael Gordon is chief investment officer equities at BNP Paribas Asset Management