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Wall St's appeal for new rules is not altruistic

By Terrence Hendershott
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One would think that Wall Street, embodied by the New York Stock Exchange, would be the last industry to go to Washington advocating more government regulation. Yet, as reflected in recent US congressional hearings, including this week's by the Senate banking committee, and widespread comment on the Securities and Exchange Commission's attempts to transform stock market regulation - known as regulation NMS (national market system) - this is exactly what is happening. Some of Wall Street's most famous names - including the SEC itself in its latest proposal - have joined the NYSE in the tried and tested approach of appealing to government to protect their franchises in the name of protecting consumers.

At the heart of regulation, NMS is the so-called trade-through rule that requires orders to be sent to the market with the "best" price. The NYSE and its status quo protectors say the rule is needed to protect investors by encouraging limit orders. As the story goes, without a best prices requirement, market participants will irrationally ignore better prices, discouraging investors from posting competitively priced limit orders, which increases costs for all investors. So much for Wall Street's belief in efficient markets.

Free-market advocates argue that, while well-intentioned, the rule actually harms investors by inhibiting competition and rewarding less efficient marketplaces. They further note that stocks listed on the Nasdaq exchange already trade without the "protections" of the trade-through rule. If the rule helps investors, current data should show trading in Nasdaq stocks to be more expensive. To examine this, I compared the top 10 Nasdaq stocks for March 2004 with the most similar NYSE stocks. If the trade-through rule helps investors, trading of NYSE securities should be less costly than their Nasdaq counterparts. But on average, trading costs of Nasdaq stocks were half those of NYSE stocks - that is, Microsoft was less than half as expensive to trade as General Electric. This suggests that allowing trade-throughs in NYSE stocks makes more sense than prohibiting them for Nasdaq stocks.

Even more troubling is the impact on technological innovation. Trade-through rules implicitly require mandated regulatory market linkages. These inevitably suffer from underinvestment and technological obsolescence and, in turn, kill innovation and competition by forcing all markets toward uniform mediocrity. While William Donaldson, SEC chairman, says regulation NMS is the "most significant modernisation" of our securities markets, experience has shown that rules favoured by existing vested interests rarely lead to transformation.

Finally, some companies clearly prefer the Nasdaq market structure: beyond the fact that most major technology companies list on Nasdaq, Google last week chose to list on Nasdaq and earlier this year, six large NYSE-listed companies chose dual listing on the NYSE and Nasdaq. If companies prefer markets with different structures and rules, why should regulators homogenise the markets, thereby limiting choice and stifling innovation?

In 1975, when Congress created the framework that led to the current trade-through rule, it was nearly impossible for investors adequately to monitor and access all marketplaces. Innovations in computing and communications technology have eliminated these barriers. Now anyone, anywhere, can access the markets. This has enabled other investors to challenge Wall Street's dominance of trading in Nasdaq stocks. Just as the flea markets of the world would love to force everyone to visit them before they can buy and sell directly on eBay, Wall Street and the NYSE are seeking regulatory protection to stave off such competition in NYSE stocks.

The SEC's move to extend the comment period on regulation NMS and the various congressional hearings reflect the contentiousness of these issues. It is to be hoped that the Senate banking hearings can deter incumbents from quibbling over small changes to technologically obsolete 30-year-old regulations. Rather than searching for an ephemeral regulatory solution to the complex issues of competition between securities markets, a broader approach focusing on fostering innovation and competition is needed. The SEC's priorities should be to allow technology, not regulation, to solve problems and to clean up markets by forcing greater transparency and equitable treatment of all investors. Instead, Wall Street wants to keep and extend its special privileges by increasing regulation benefiting itself.

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