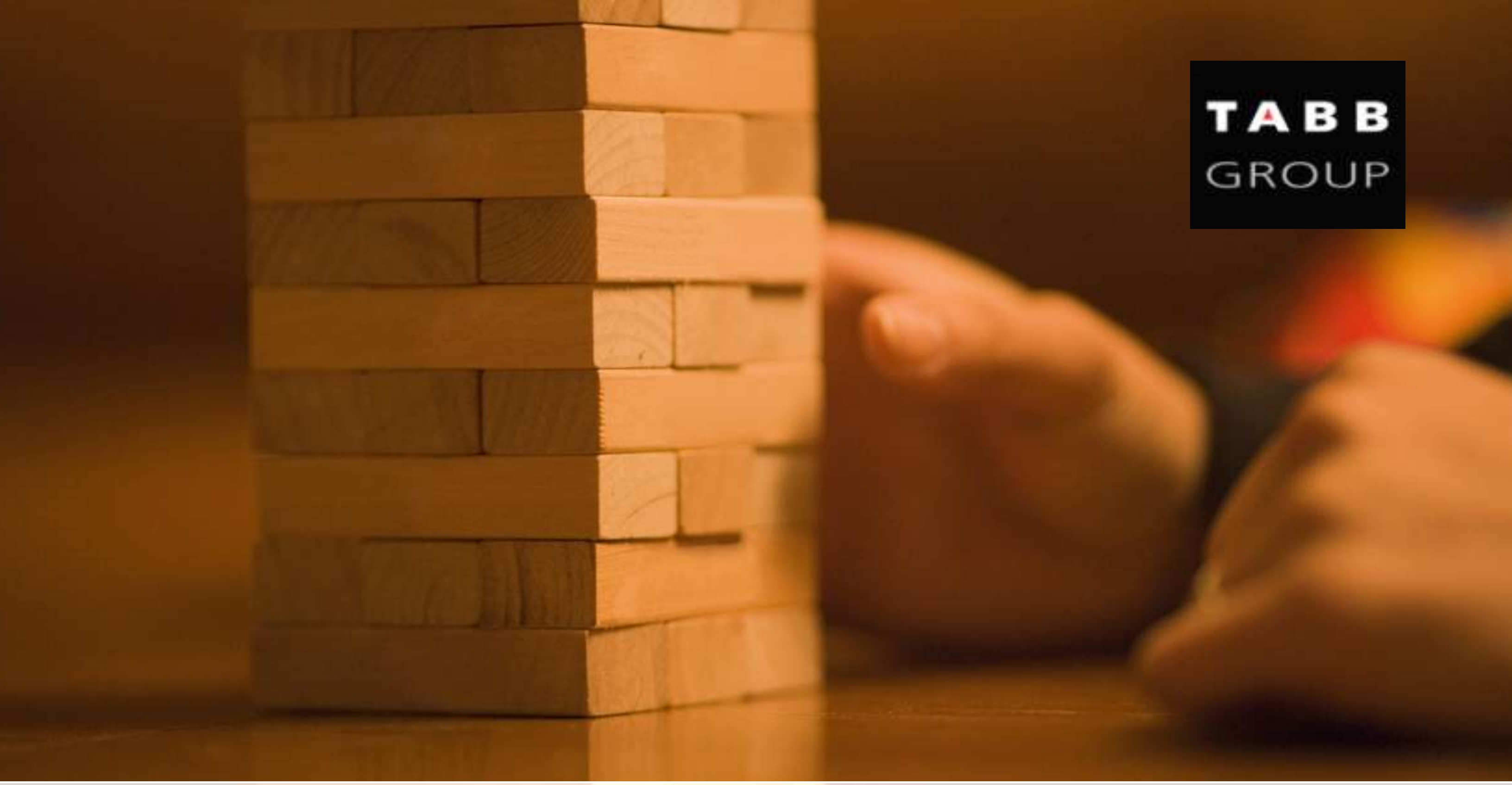


The Sky is Falling:

US Equity Market Structure Confidence Survey Results

On August 6, TABB Group measured the institutional community's confidence in US equity market structure. We received 260 responses. The highlights of this survey include:

- Only 2% of respondents rate their confidence as very high, down from 12% in May 2010 (see page 3). 26% have very weak confidence, up from 3% in May 2010 (see page 3)
- When measuring the impact of the Knight trading issue, most participants believe it has had a medium impact on market structure confidence (see page 5).
- More than half of participants have not changed their investments in the wake of these events (see page 6).
- The most popular regulatory action among respondents to improve market structure is to reduce fragmentation (see page 9).

Adam Sussman
V10:031
August 2012
www.tabbgroup.com

Related Content

Over the last few weeks, TabbFORUM has published several commentaries related to market structure, software testing and high-frequency trading. Below is a short list of our favorites.

Fragmentation is Redlining the Markets
http://www.tabbforum.com/opinions/fragmentation-is-redlining-the-markets

HFT and the Hidden Cost of Deep Liquidity
http://www.tabbforum.com/opinions/hft-and-the-hidden-cost-of-deep-liquidity

The Whipping Post
http://tabbforum.com/opinions/the-whipping-post

Hedge Fund Death by Rogue Algorithm?
http://www.tabbforum.com/opinions/hedge-fund-death-by-rogue-algorithm

When I Eat Pink Slime
http://www.tabbforum.com/opinions/when-i-eat-pink-slime

The Failure of Continuous Markets
http://www.tabbforum.com/opinions/the-failure-of-continuous-markets

What Will It Take for Real Capital Markets Innovation?
http://www.tabbforum.com/opinions/what-will-it-take-for-real-capital-markets-innovation

The 2010 Flash Crash: Happy Second Anniversary
http://www.tabbforum.com/opinions/the-2010-flash-crash-happy-second-anniversary

Introduction

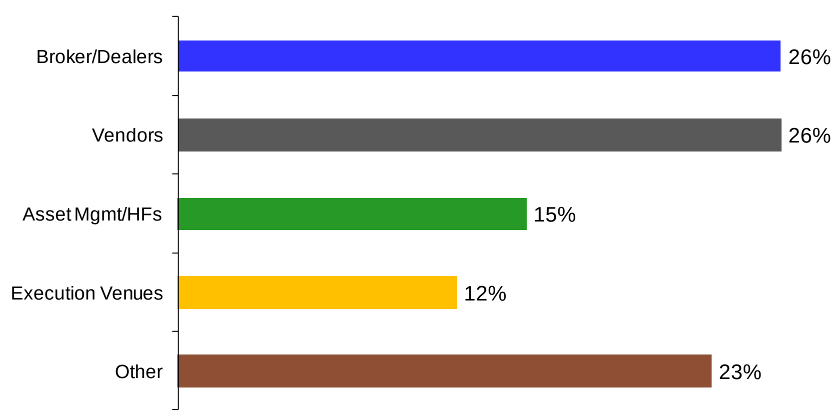
When we realized the enormity of the problems facing Knight Capital Group, we were concerned. First, we were worried about the many folks at Knight with whom we have strong relationships. The level of uncertainty we felt is incomparable to what employees must have been facing but it was an anxious moment for the entire industry. No matter what your opinions are on the current state of market structure, having a firm that controls about 10% of share volume suddenly disappear from the market is not a confidence booster.

As the initial shock subsided and the chances for survival increased, our concern shifted to the impact the event would have on the market. As I wrote in my initial commentary, the idea that a firm as well respected as Knight could nearly bankrupt itself because of a software problem left me wondering about the hidden costs of our market structure. In other words, I still believe that transaction costs are low and efficiency is high. But what's the cost? Is market structure comparable to national security, where freedom and safety are a constant tradeoff?

It was then we decided to reach out to the community and find out what impact, if any, this event had on attitudes toward market structure. We have done this type of survey twice before: after the Flash Crash and after the Facebook IPO. As a company that looks at and conducts numerous outreach projects, we are aware of the limitations and biases of various methodologies. We received 260 responses between August 6th and August 13th. The caveats in interpreting the data represented on the following pages include:

- Participants self-selected the type of firm where they are employed.
- Some of the questions are leading because of the case statement limitations in the polling software we use.
- Most of the questions are multiple choice, though we did allow participants to select "Other" and write in answers.
- Our community is heavily skewed toward the institutional community. We do not purport that it represents the broader retail investor community.

Exhibit 1 Survey Demographics



Source: TABB Group

Confidence Continues to Weaken

As the data on the following pages will make clear, there is little confusion among participants between the lack of internal controls at an execution venue or broker/dealer and the broader issues facing market structure. Nonetheless, there is concern that the cracks in the system exposed during the Flash Crash and the recent rash of technology-specific issues exposes the industry to unacceptable risks.

In early 2010, the flash order controversy erupted. Flash orders captured the imagination of national press and major media outlets and initiated greater coverage on market structure issues and high-frequency trading than ever before. While the flash order issue faded quickly, May 6, 2010, cemented equity market structure as a hot topic. But, among the institutional community, confidence in market structure was relatively strong at the time.

Exhibit 2 Market Structure Confidence, 2010-2012

Source: TABB Group

However, over the following two years, market structure confidence continued to weaken. We believe that this erosion in confidence has been due to tough market conditions, declining market volumes, the Pipeline Trading scandal and, more recently, botched IPOs. (Our June 2012 survey was conducted in the wake of the Facebook IPO).

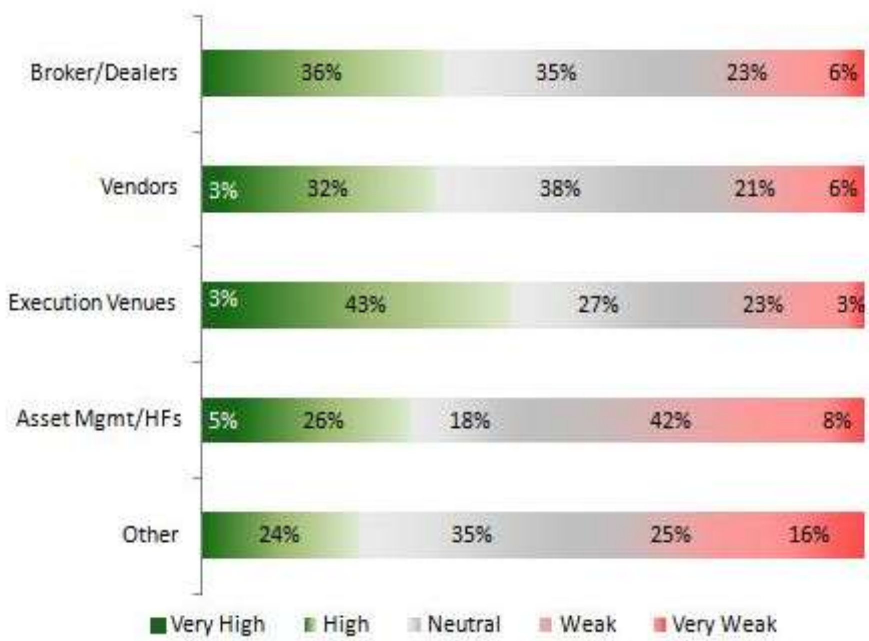
It is interesting to note that while overall confidence has weakened, the percentage of folks with a neutral view has remained constant. So while we cannot measure the movement of specific individual’s views, it appears that attitudes are changing in linear fashion, moving from very high to high, high to neutral and so forth.

The Skeptical Buy Side

It is not surprising that among the four main types of survey participants, the buy side is the least confident in US equity market structure, with 50% confessing to a weak or very weak confidence level. The buy side has long been unsatisfied with the amount of transparency into order routing practices among broker/dealers and the venue selection process within smart order routers. More recently, they have been concerned about the impact of ETFs and other index trading products on single stock liquidity.

Among broker/dealers, vendors and execution venues, there is a relatively consistent degree of confidence, with execution venues having the highest degree of confidence and broker/dealers with the greatest percentage of weak or very weak ratings. This latter point (because it’s not surprising that exchanges/venues are the most confident, right?) is both surprising and sobering. Broker/dealers hold primary responsibility for solving market structure complexity on behalf of clients. If their confidence has weakened, does that also point to a lack of conviction in their abilities?

Exhibit 3 Market Structure Confidence August 2012, By Firm Type



Source: TABB Group

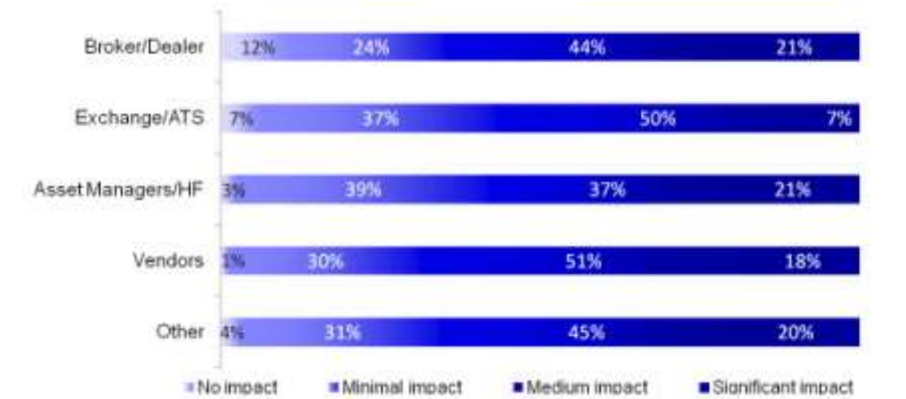
Jenga!

Market structure, when it goes awry, can be a significant factor in the loss of confidence in the markets, though on its own is not sufficient to restore that confidence. It is much like plumbing. A beautiful house with bad plumbing is not very attractive but no one buys a house because its toilets flush nicely.

There is a legitimate argument that Knight's trading issues have nothing to do with market structure and any attempt to the link the two is specious and misleading. And yes, I did receive a few calls concerned that my questions were negatively slanted. Point taken.

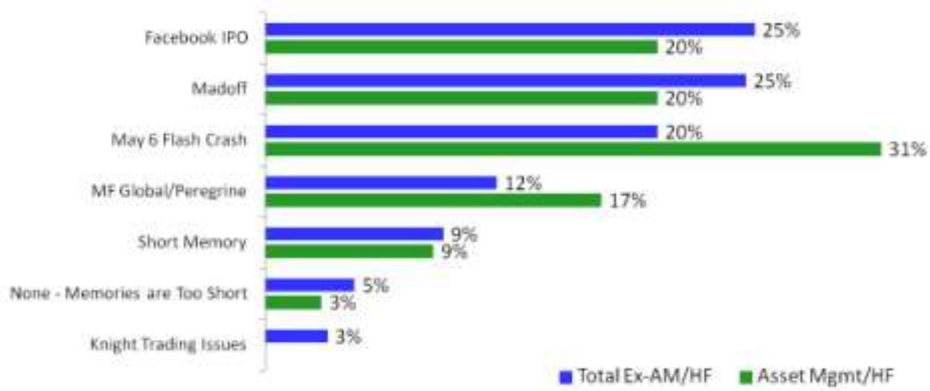
Nonetheless, I believe the two charts below taken together accurately reflect the impact of Knight on market structure confidence and US equities overall. More people believe that the incident had a minimal impact than a significant impact, but very few believe it had no impact at all. Then, when asked which event had the greatest long-term impact on overall retail confidence Knight barely ranked. So, which is it? My conclusion is that Knight's issue was like the removing the fatal block during a game of Jenga! If it occurred earlier, no one would have noticed.

Exhibit 4 Impact of Knight Trading Issues on Market Structure Confidence



Source: TABB Group

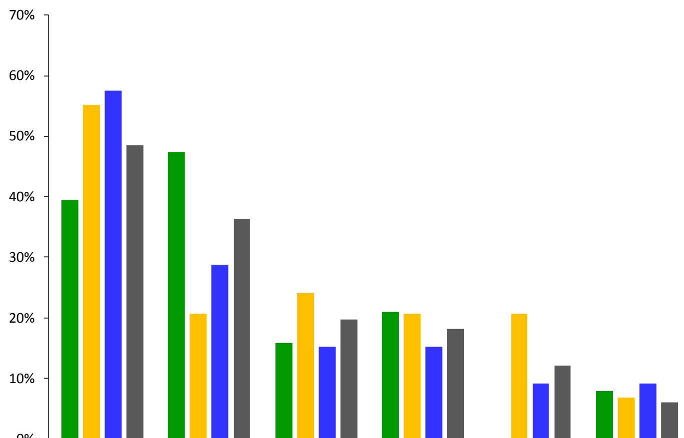
Exhibit 5 Which of the following have the greatest long-term impact on retail investor confidence?



Source: TABB Group

Similarly, when we asked folks what it would take to revive investor confidence in US equities, market structure rated highly. However, it was only the most selected choice among asset managers and hedge funds. (It was a multiple choice question with the ability to select "Other" and write-in. We added "New President" to the list of choices after the first 30 responses. "Global Economy" was the most common written response).

Exhibit 6 What do you believe it would take to revive investor enthusiasm for US equities?



	US equities outperform other markets	New market structure regulations	New President	Lower capital gains tax	More IPOs	Global Economy
Asset Manager/Hedge Fund	39%	47%	16%	21%	0%	8%
ATS/Exchange	55%	21%	24%	21%	21%	7%
Broker/Dealer	58%	29%	15%	15%	9%	9%
Vendors	48%	36%	20%	18%	12%	6%

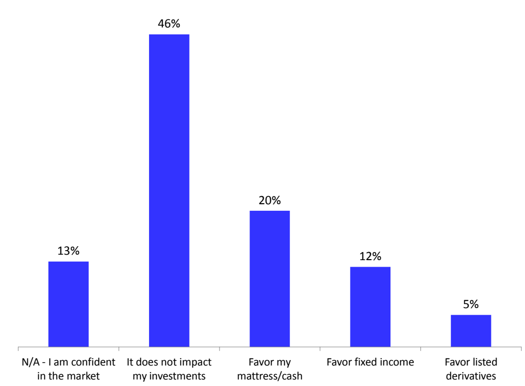
Source: TABB Group

Broker/dealers and execution venues rated "New market structure regulations" as the least important to reviving investor confidence. In their minds, confidence is a function of stock market returns. Related are consequences of tax law (after-tax returns). For example, the uncertainty regarding capital gains undermines confidence in equity markets.

If we could go back and add another choice to the list, it would be the "Global Economy" since it was the most common response under "Other". In retrospect, the overall uncertainty facing the global economy and all the factors that are causing that uncertainty, are undoubtedly having an impact on investment behavior.

This view is reinforced by the reported impact of *market structure confidence* on participants' own investments. Confidence has weakened for nearly 50% of respondents but they have not changed investments as a result. The overwhelming choice of investment among those impacted is, unsurprisingly, cash.

Exhibit 7
How Does Lack of Confidence Impact Your Investments?

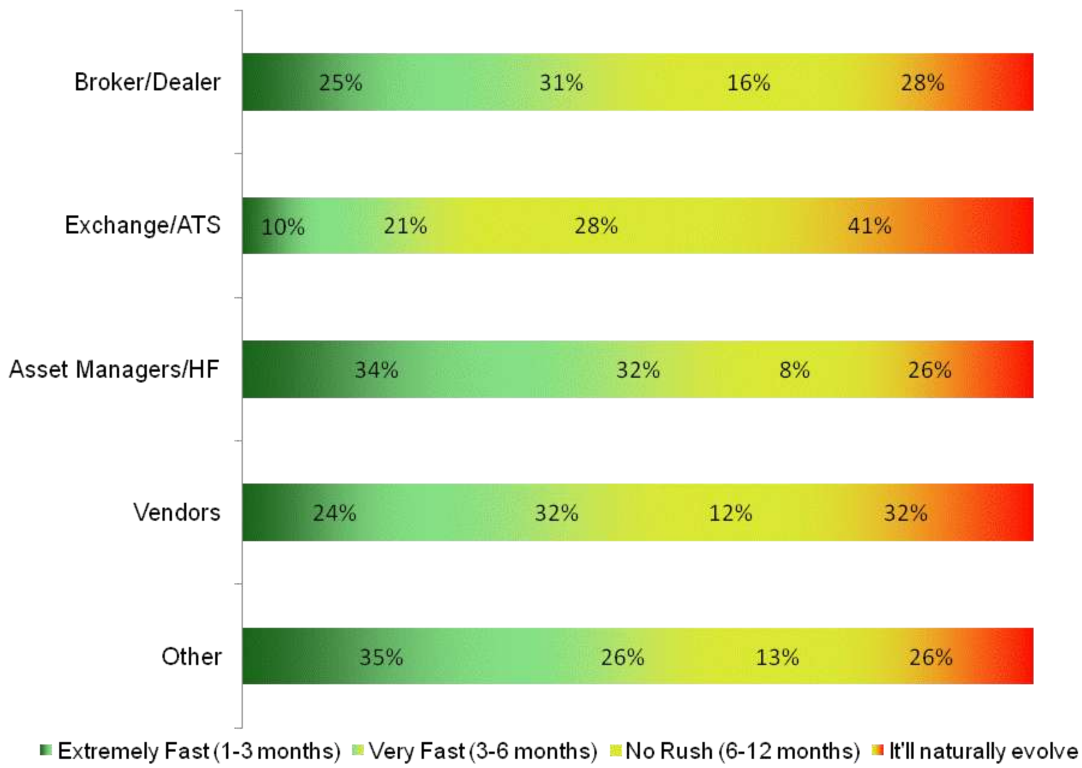


Source: TABB Group

Next Steps

If the consensus is that the recent spate of technology issues have damaged the reputation of US equities, even if it's just one contributing factor among many, the next question is who will lead the charge to further reduce this type of risk. When it comes to regulators, the mantra seems to be "sooner rather than later." This is a shift from the recent past. After the Flash Crash, folks were worried about the unintended consequences of regulations. Now, in the context of protecting the markets from further technology glitches, participants want action.

Exhibit 8
How Quickly Should Regulators Address How Markets Can Be Protected Against Flawed Technology?



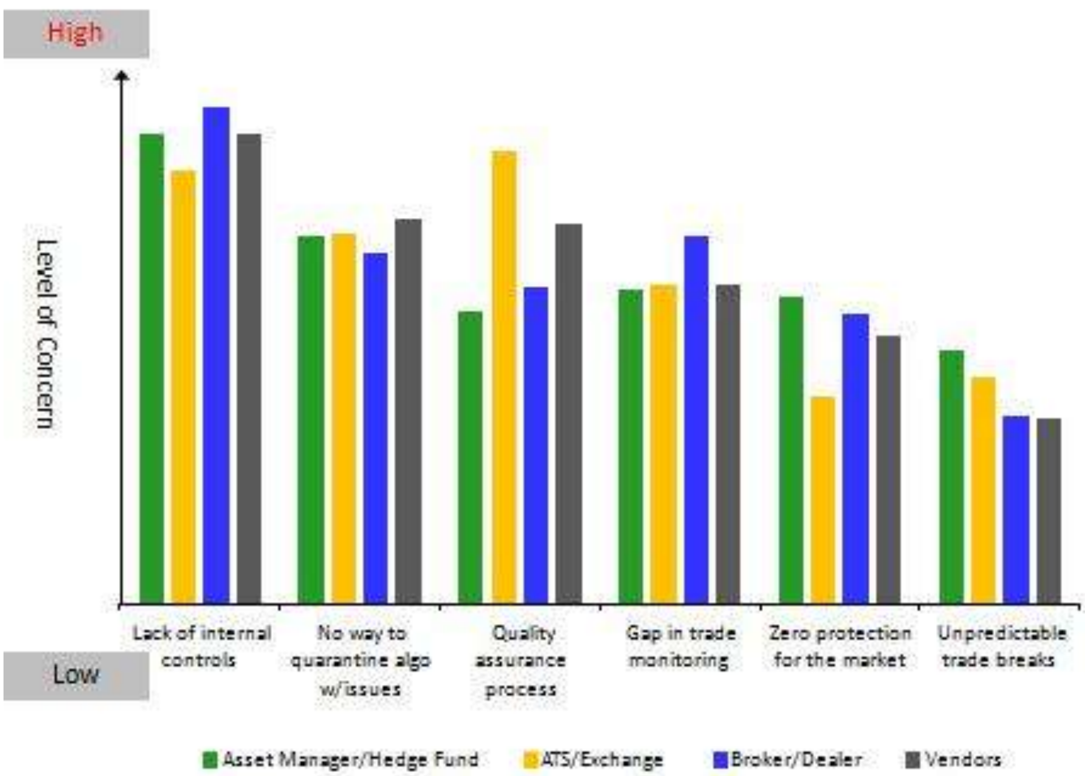
Source: TABB Group

Rank Your Top Concerns

There are two types of actions regulators will likely address. As discussed in a webinar I did recently with NASDAQ, regulations can be implemented at the broker/dealer level and/or at the exchange level. Clearly the market access rule was about reducing risk at the broker/dealer level, while limit up/limit down is a protection at the exchange level. And while limit up/limit down would have dampened the impact of the Knight trading issue, it is a last resort – it treats the symptom, not the cause.

In the question below, we asked participants to rank their concerns in regard to Knight's trading issues. The primary concern – lack of internal controls – is clearly a broker/dealer issue. But the secondary concern is more of an exchange issue – how do we quarantine a flawed algorithm from negatively impacting other market participants. Thus, when the industry thinks about how to minimize the systemic risk of technology, we need to think about it in terms of both preventive medicine and emergency care.

Exhibit 9
With regard to Knight's trading issues, rank the following concerns:



Source: TABB Group

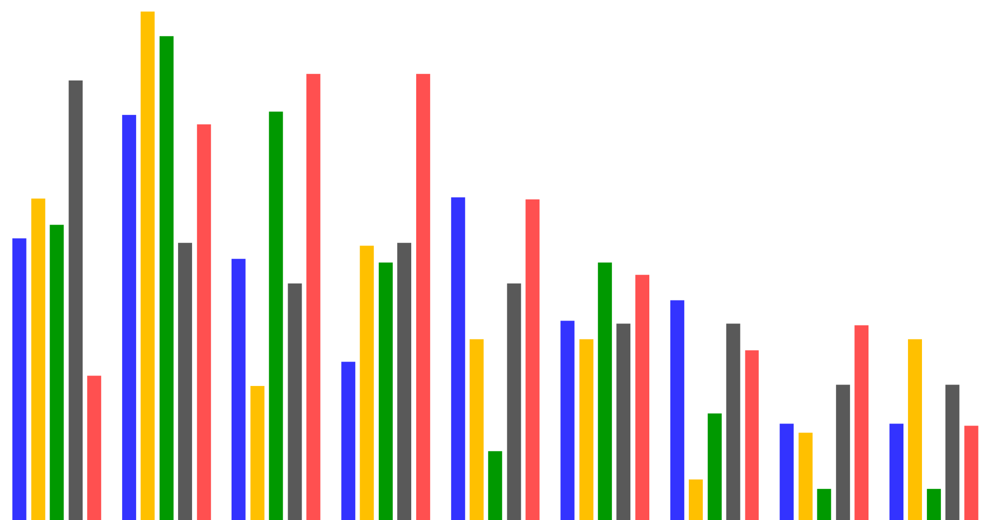
What Should Regulators Do?

Timing aside, we asked what actions, if any, regulators should take. The question is trying to capture if participants feel that there are larger issues and that the more specific events are symptomatic. The overwhelming response was that fragmentation needs to be reduced, as discussed in Larry Tabb's recent post on TabbFORUM However, as the poll suggests, fragmentation is not related to the issues surrounding Knight. Fast tracking the limit up/limit down would seem to be a no-brainer as it would dampen the impact of future automated trading problems, but asset managers and hedge funds seem dissatisfied with this choice. (Similar responses were given to narrowing the band for trade halt to be triggered).

Few participants believe that regulators ought to have direct oversight of algorithms via a safety control board for algorithms but we are hearing more talk about the industry trying to come up with some type of best practice, such as HFT9000. Slowing down the market or widening tick size both had modest degrees of support while a financial transaction tax and an industry error account for algorithms had the least.

Exhibit 10

What new market structure regulations would help minimize the types of events we have seen in 2012 or, more broadly, help the industry regain the trust of investors? (Select all that apply)



	Nothing, KCG fail is not about market structure	Reduce fragmenta tion	Slow down market	Impose Safety Control Board for Algos	Fast track limit up/limit down	Widen tick size	Narrow band for trade halt trigger	Financial transactio n tax	Industry algo error account
Broker/Dealer	21%	30%	20%	12%	24%	15%	17%	8%	8%
Exchange/ATS	24%	38%	10%	21%	14%	14%	3%	7%	14%
Asset Managers/HF	22%	36%	31%	19%	6%	19%	8%	3%	3%
Vendors	33%	21%	18%	21%	18%	15%	15%	10%	10%
Other	11%	30%	33%	33%	24%	19%	13%	15%	7%

% of Participants

Source: TABB Group

About

TABB Group

TABB Group is a financial markets research and strategic advisory firm focused exclusively on capital markets. Founded in 2003 and based on the methodology of first-person knowledge, TABB Group analyzes and quantifies the investing value chain from the fiduciary, investment manager, broker, exchange, and custodian. Our goal is to help senior business leaders gain a truer understanding of financial markets issues and trends so they can grow their business. TABB Group members are regularly cited in the press and speak at industry conferences. For more information about TABB Group, go to www.tabbgroup.com.

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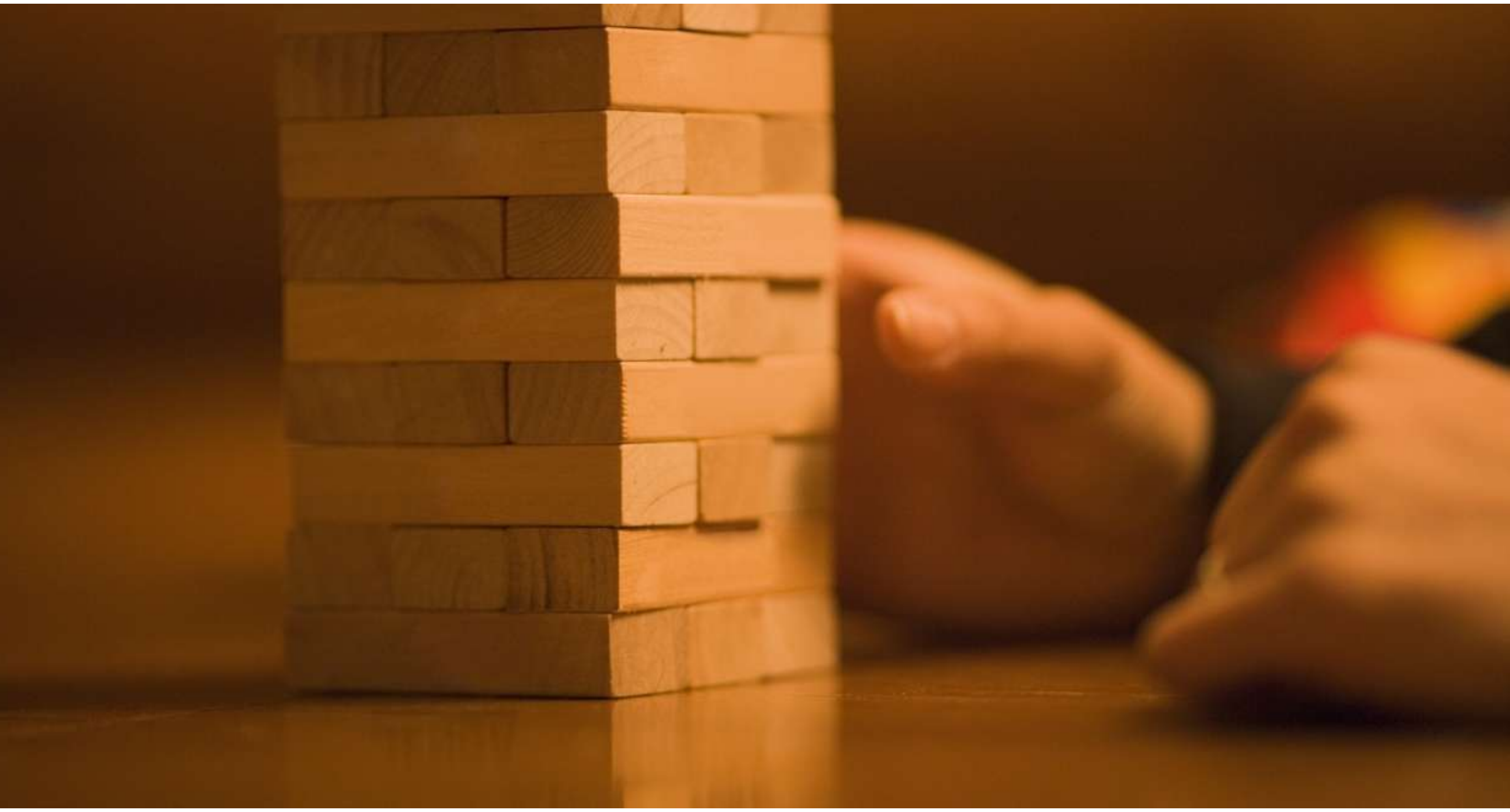
Adam Sussman is a partner and director of research at TABB Group. Sussman joined the firm in 2004 as a senior analyst. Before that he served as a senior product manager responsible for order-management systems, routing and next-generation trading tools focused on the equities and options markets at Ameritrade, Inc., a brokerage industry subsidiary of Ameritrade Holding Corp. Sussman earned a BA in philosophy and comparative literature at the University of Rhode Island. At TABB Group, Sussman has authored a number of reports, including "US Equity Mid-Year Review 2012"; "Reinventing Capital Markets Infrastructure"; "Russia 3.0: Liquidity Perestroika?"; "Trading Net Alpha 2012"; "US Equity High-Frequency Trading: Strategies, Sizing and Market Structure"; "Equity Risk Models: The Evolution of Predictions"; "Equity Swaps and OTC Options: A Buy-Side Perspective"; "International Perspective on Transaction Cost Analytics"; among others.



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