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INVITED EDITORIAL

Combating Turbulence in the Equity Market: *Get the Listed Companies on Board*

Nazli Sila Alan, Timothy Mahoney, and Robert A. Schwartz

What equity market participant could ever forget the month of October 1987? It was a wild, turbulent time, and Monday, October 19 was a black day: the Dow Jones Average of 30 industrial stocks dropped 508 points on that day to close down 22.61%. But the dramatic plunge on the 19th is not what captures our attention in this piece. Rather, we are drawn to the sharp market swings of more than a quarter of a century ago, and the fact that, to the current day, bouts of sharply accentuated, short-period volatility continue to characterize our equity market.[1] How might we deal with such turbulence?

Our answer: get the listed companies involved in providing liquidity for their own shares. On October 19, more than 604 million shares of NYSE-listed stocks traded. Although this number was enormous relative to the New York Stock Exchange's (NYSE) 1987 average daily trading volume of 189 million shares, it was only roughly 1% of the total number of shares outstanding.[2] This very small percentage suggests that a corporation could relatively easily bring meaningful liquidity to the market for its stock.

October 1987 was fraught with major economic uncertainties: concern about a federal budget deficit, a trade deficit, rising interest rates, a threat of renewed inflation and, as the market opened on October 19, news that an Iranian oil platform in the Persian Gulf had been bombed by warships thought to be American. But the precipitous decline on October 19 was not attributable to fundamentals alone. In response to the falling market, portfolio insurance programs had kicked in, driving prices into virtual free fall as orders and quotes disappeared on the buyers' side of the market.

John Phelan, then CEO of the NYSE, recognized that the October 19 plunge was in good part a technical event driven by the portfolio insurance programs. To reassure investors and to stem a further decline, Phelan stepped forward. On October 20, he and his chief lieutenants at the exchange hit the telephones, asking CEOs and other top brass at the listed companies to buy back their own shares. His efforts were successful. According to a report by the SEC's Division of Market Regulation, close to 600 firms announced open-market repurchase programs during the two weeks following the crash.[3] With this corporate support, the market regained normality.[4]

And so a powerful idea was pushed to the fore: get the listed companies involved in providing liquidity for their own shares. Phelan, however, was not the first to think of involving listed companies in the quest for improved market quality. Recognizing the accentuated range over which share prices can fluctuate, in their classic book, Graham and Dodd [1934] wrote:

> "It follows that the responsibility of managements to act in the interest of their shareholders includes the obligation to prevent—in so far as they are able—the establishment of either absurdly high or unduly low prices for their securities."

Let us further consider the need to get listed companies involved.

THE NEED TO ENHANCE MARKET LIQUIDITY AND QUALITY OF PRICE DISCOVERY

As the flash crash on May 6, 2010, dramatically underscored, markets are prone to unwarranted instability. Virtually every day, intra-day price volatility is elevated.[5] Unsurprisingly, on both sides of the Atlantic regulators are giving a good deal of attention to proposals for improving market liquidity and the quality of price discovery.

These proposals include imposing a special fee on trading, requiring that unexecuted orders remain posted for a minimum resting time, and attracting a larger portion of market-maker capital, either by granting dealers subsidies or by giving them additional perks. Will regulatory approaches such as these accomplish their desired objective? Each of them has been criticized, and we wonder if regulators are looking in the right direction.

To answer this question, it is important to recognize that 1) insufficient liquidity provision and the complexity of price discovery cause accentuated volatility; 2) our continuously trading markets achieve imperfect liquidity and price discovery through orders placed by public limit-order traders, by traditional market-makers, and by high-frequency traders (HFT), a more recent breed of participants who also have a market-maker role; 3) in addition to the participants in the individual trades, a wide spectrum of investors is affected by intra-day volatility and the attending complexity of price discovery.

For the most part, regulatory proposals have focused on controlling the limit-order traders, dealers, and HFT participants. However, these proposals fail to take into account an important reality: in acting out of their own self-interests, none of these participants is incented to do whatever is best for the market as a whole. Why? Because price determination in the equity markets is a public good, precisely because investors who are not trade participants care about and are affected by the prices that trades establish. Market prices are used to mark positions to market, as well as in derivative trading, estate valuations, mutual fund valuations, dark pool pricing, and by corporations assessing their costs of capital.

Economists recognize that free markets undersupply public goods. We should not try to overcome this reality by imposing cumbersome carrot and stick rules on standard market participants. Sound public policy should honor the fact that not one of them—not the limit order placers, nor the standard market makers, nor the new HFT players—is incented to supply adequate amounts of the public good. Why should they? But if these participants are not so incented, who is? The listed companies themselves, as we will explain shortly. First, we consider the role of traditional market makers.

TRADITIONAL MARKET MAKERS

The standard view in the microstructure literature is that market makers are suppliers, not of liquidity per se, but of immediacy, while the "naturals" provide liquidity itself. That is, public buyers supply liquidity to public sellers (and vice versa). This is most understandable. Market makers certainly need to keep their share inventories in reasonable balance, and no market maker can continue to buy shares from public participants who are looking to sell without re-liquefying by selling shares to other public participants who are looking to buy (and vice versa). In this context, the bid–ask spread is the market maker's compensation for providing immediacy to public participants.

However, inadequate immediacy provision is not the problem that regulators are addressing (and, in any event, immediacy for large-cap stocks is largely provided by limit orders that public participants place in the book). From a public policy perspective, the problem is the price turbulence that occurs when the book becomes unduly sparse. Controlling this turbulence calls for providing supplemental liquidity.

A market maker's economic function has historically extended beyond providing immediacy. The NYSE specialists of old were responsible for making fair and orderly markets, and both specialists and Nasdaq market makers have played key price discovery roles. In today's turbulent environment, it is not surprising that regulators would look to traditional market makers for answers. However, it is unrealistic to expect traditional market makers to apply their capital with an unprofitable intensity, and it is important to recognize that the public goods benefits that enhanced liquidity and price discovery bestow on the broader community are not monetized for market makers. With this in mind, we turn to a market maker-type role that a listed company can play.

LISTED COMPANIES

Some may not think that a listed company's functions extend to serving as a market maker. An automaker, for instance, is in the business of producing cars, not making the market for its stock. But this understanding is unduly limited. A company should be involved, for it is better positioned than a traditional market maker, limit-order trader, or HFT participant to internalize the public goods benefits that attend deeper liquidity provision and enhanced price discovery. This is because a corporation seeks not to realize profits from trading per se, but to maximize the value of its shares. To the extent that poor price discovery and turbulent price changes have negative consequences for the broader array of market participants, the value of a company's shares can be impaired, raising its cost of capital.

Because the markets for small- and medium-sized companies are generally less liquid than those for blue chips, we expect that smaller companies in particular would benefit from instituting stabilization programs. Moreover, because they typically have lower free float, smaller companies are more prone to being gamed with relatively less money. We also suggest that the more widely corporate liquidity-provided stabilization programs are used, the more effective they will collectively be in tempering broad market swings that include stocks of all cap sizes.

Precedents exist for companies having meaningful associations with market makers for their stocks. Historically, NYSE specialists have maintained contacts with the management of the companies whose shares had been allocated to them. Currently, in five European countries (France, Germany, Italy, the Netherlands, and Portugal) sell-side intermediaries called "designated sponsors" contract with the listed companies (generally one or two to a company) to enter orders that, by reducing spreads, make the markets for the companies' shares more liquid.[6] And corporations have historically bought back their own shares, not simply because they feel the price is right from an investment prospective, but also to stabilize their share values when they believe a short-run price decrease is not justified.

Schwartz [1988] and more recently Alan et al. [2015] have set forth a specific procedure by which a listed company could more directly provide supplemental liquidity for its shares. The proposal calls for a company to establish a fund run by a third-party fiduciary to buy back the company's shares in a falling market and sell its shares in a rising market. Importantly, the procedure would be totally transparent, with all parameters announced well in advance and the companies committing to the program for a prespecified, adequately long period of time.

When it comes to a listed company taking a more direct role in making a market for its own shares, a primary concern is the possibility that the firm will manipulate its share price. Alan et al. [2015] address this issue (along with the more general problem of gaming). They argue that the defense against manipulation (and gaming) lies in the high degree of transparency that their procedure calls for, along with requiring that all relevant parameters be pre-announced and that a third-party intermediary, such as a designated sponsor, play an important fiduciary and advisory role. Moreover, the transparent presence of the large corporate orders would make it more difficult for other participants to manipulate the market.

Any specific plan to have a listed company bring supplemental liquidity to the market would unquestionably require further thought and analysis. Nevertheless, one reality is clear: for the public goods benefits that additional liquidity would provide to be more fully realized, the listed companies must be involved.

ENDNOTES

[1]Following Black Monday in 1987, the market reversed direction on October 20 and 21, with the Dow regaining 289 points to end the day 16.03% higher than its October 19 close. October 26 saw another big drop (156.83 points or 8.04%), after which the DOW continued to climb for the remainder of the month.

[2]See http://www.reuters.com/article/2012/10/19/us-usa-markets-blackmonday-idUSBRE89I0YA20121019 and http://graphics8.nytimes.com/packages/pdf/nyregion/city_room/20071019_CITYROOM.pdf.

[3]See Division of Market Regulation [1988].

[4]Eventually, many firms did not actually carry the programs out, as discussed by Netter and Mitchell [1989].

[5]For further discussion, see Alan and Schwartz [2013].

[6]In practice, designated sponsors have supplied liquidity for the less liquid small-cap and mid-cap stocks, not for blue-chip stocks.

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