Washington Decoded

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Roger and the NYSE

By Max Holland

Wall Street, the fall of 1989. For the second October in three years, the New York Stock Exchange gyrates hundreds of points an hour without apparent rhyme or reason. Brokers, corporate officers and individual investors – many of whom operate on the quaint notion that big shifts in the market should correlate with fundamental changes in the economy – scream bloody murder. Almost uniformly they point to computer-aided program trading as the culprit and demand reforms. To quell the outrage and buy time, the NYSE reaches for a hoary American tradition invoked by government and business alike in such situations. It appoints a panel to study the problem.

Last month, after five months of due diligence, the Market Volatility and Investor Confidence Panel issued its report. A principal finding, according to panel chairman Roger Smith, outgoing CEO of General Motors, is that there is no problem, or at most one that is merely perceptual: " . . . inaccurate information concerning trading practices and strategies has helped create mistrust of activities that are, in fact, inevitable and desirable features."

One assertion in that sentence is beyond dispute. Strategies such as program trading, especially of stock-index futures, ***are*** desirable (read, ***lucrative***). The question is, for whom? Come up with the answer, and it becomes obvious that Roger Smith & Co. have delivered a directed verdict favorable to a handful of investment houses and institutional investors.

As the report itself makes plain, these interests now dominate the nation's equity and equity-related markets. Institutional investors – banks, pensions funds, and insurance companies – control assets worth $3.8 trillion, equivalent to 77 percent of America's 1988 GNP (up from 31 percent of 1950 GNP). Approximately 30 percent of this sum, or $1 trillion, is invested in the equity markets. Looking at it another way, the equivalent of 44 percent of total NYSE market value is owned by institutional investors. An additional $300 billion, or about one-third of these institutions' equity investment, is devoted to the portfolio, or baskets of stock, investments that are the basis of program trading. Meanwhile, about 10 investment houses account for 90 percent of all program trading.

Given these interests' hegemony over the equity market, and their concurrent stake in program-trading strategies, the "no problem here" finding of the panel was utterly predictable. For, after institutional investors have spent years, and millions of dollars, learning how to use their vast sums to exploit the market, can anyone doubt their resolve to control the conclusions of a 19-member panel? Nor was it simply the participation of Morgan Stanley and Salomon Brothers, two of the biggest program traders, that made the panel a stacked deck. General Motors has one of the biggest pension funds in the nation, and that fund is a primary user of newfangled trading strategies. During the October, 1987, meltdown, for example, GM's pension fund was one of the biggest program sellers, dumping blocks of stock on the market in wave after wave. The irony is that markets whipsawed by program trading raise the cost of capital for GM and other corporations. They're raiding Peter to pay Paul.

There is one mild surprise in the Roger Smith report, however, and that is the willingness of some key traders and institutional investors to disregard fundamental market principles. The panel advocates mandatory "circuit breakers," or trading halts, in all US markets whenever the Dow Jones spins out of control by more than 100 points. These halts would last from one to two hours, depending on the severity of the market stress. Yet historically, the factor that set the New York Stock Exchange apart was its standing as the only continuous equity market in the world. Regardless of whether droves of investors wanted in or out, the market was always open during trading hours. That fact, more than any other, created the confidence that built New York's capital markets into one of this country's greater economic assets.

Now some institutional investors are willing to violate that principle in their zeal to protect program-trading strategies. Unwilling to address the causes of market volatility, yet under orders to allay anxieties about it, the panel chose to treat its symptoms. Shutting down the markets in any circumstances short of a calamity will more likely, however, induce panic than cure it, and deep inside the report an academic expert says just that. "Closing the market creates uncertainty . . . and makes it impossible for [market] forces to work efficiently," writes finance professor Sanford Grossman of the Wharton School.

History has repeatedly proved, in both the political and economic spheres, that concentrations of power give rise to abuses in power. Some of the changes in the market over the past decade are progressive and legitimate. But overall, the power of finance capital in American markets is too great, too unrestrained, and too unaccountable. The stock exchanges, which should function as a service to both capital and corporations, are instead in thrall to the former.

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