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Why financial market regulations need to focus on two-way pricing

By Richard Olsen

In recent months, stock exchanges have come into the public spotlight for their business practices. The introduction of flash orders that give preferential treatment to a certain group of customers has undermined public confidence in stock exchanges as institutions that vouch for fair market prices. The introduction of flash orders happened in the wake of a development that has received little publicity. There is a growing scientific literature in finance that explains how market prices depend on the details of the order flow and how traders can influence market prices. An increasing number of market participants take advantage of these discoveries for their own and their investors' advantage.

This development raises a serious concern, what is a fair financial market, how should we organize our financial markets, what can regulations ensure that the financial system functions in a way that is optimal for society as a whole and does not favor one particular interest group. I argue that market makers, who are price setters, should have an obligation to commit to a two-way price, at which they are prepared to both buy and sell. On the basis of the width of the spread and the relative positioning of the bid and ask quotes compared to other competing market makers market participants will then be able to read the intentions of the market maker. The obligation to post two-way prices would be an effective means to prevent abuse and contribute to market efficiency.

Historically, stock exchanges played a key role. At a time, when there was no telephone or Internet, a stock exchange was a meeting place, where market participants could come together and bid for financial instruments in a competitive environment, where price determination could be fair and unbiased. Every stock exchange had a set of rules, which market makers, typically called brokers, had to abide by. One of the most important rules was the practice that market makers have to make two-way prices offering to buy and sell at the same time. This rule was key for achieving market efficiency; by forcing a market maker to post two-way prices abuse of information could be prevented.

Typically, a market maker is at the other side of every trade. Regular market participants do not trade directly with each other; there is always a market maker that acts as an intermediary. Every market maker has customers that trade with him and uses his execution services to implement their trades. In doing so, he sees their activity, including limit orders, and can analyze their positions. He can take advantage of this information to make inferences about his customers' future trading behavior and on the basis of this make predictions about future price moves.

Whenever a market maker posts a competitive offer, a trader has to ask himself: does the market maker lower the price to clear his inventory or does he have an expectation of the future and wants to go short on the cheap? With two-way prices, every customer has at any time the opportunity to turn the table on the market maker and he go long and thus get onto the right side of the trade. If the market maker widens the spread to discourage his customers to go short, his customers will see this upfront and can read the intentions of the market maker.

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If you do not have intimate experience with market making, you will find these intricacies difficult to understand: Let me summarize, every market maker has the mirror position of his customers, i.e. when his customers go long, he will be short; and vice versa. Because market makers are price setters allowing them to enter into positions without paying the spread, and furthermore have inside information from their customer activity, they can skew events in their favor. Two-way pricing ensures that financial markets are a level playing field. The width of the spread in combination with the aggressiveness of the price allows market participants to see through the intentions of market makers and is an effective tool to prevent abuse.

With modern technology and the emergence of ECNs, this is an abbreviation for electronic communication networks, the modern day equivalent of a historic stock exchange; access to financial markets has been broadened. Every market participant can today post limit orders and provide liquidity in an ECN; at first sight this sounds as an advance, but in actual fact this is dangerous because sophisticated participants, who leverage the discoveries of modern finance and read the markets through tick by tick market data use this information to their advantage and generate unfair profits by moving the market price around.

Going forward we have to rethink the market regulations. Regulations need to be simple so that they are easy to implement and monitor. The practice of two-way prices was taken for granted in traditional stock exchanges. With the plethora of new ECNs and other networks to match orders, including the black pools, the necessity of two-way prices has to be reaffirmed. If we fail to do so, we open the door to manipulation of market prices. In exceptional circumstances, when market prices are close to critical thresholds where there are a lot of stop losses, the ability to manipulate price action can give rise to large price cascades that can destabilize an individual market and even cause a shock that propagates to other markets. Two-way pricing is a simple mechanism to prevent market abuse. In the buildup to the current economic crisis two-way pricing would have increased transparency and would have helped to raise warning flags of increases

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