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Market Lessons From Merck's Decline

How exchanges need to work in concert

When Merck & Co. (**MRK**) announced the morning of Sept. 30 that it was recalling its Vioxx pain medication, it caused a huge headache for patients and investors. But they weren't the only ones reaching for the aspirin. The pharmaceutical giant also created an enormous task for Wall Street's stock dealers and brokers. In the scant 75 minutes between Merck's 8:15 a.m. announcement and the scheduled opening of the New York Stock Exchange, and the frenzied hours immediately afterward, traders had to field an avalanche of orders.

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If the dealers and brokers couldn't match buyers and sellers quickly, or if they completed the trades at wildly divergent prices, their already-riled customers would be furious. They also knew that the Securities and Exchange Commission would be closely watching. The SEC is debating whether investors are best served by the NYSE's auctions conducted by "specialists" on the exchange floor or by rival electronic systems that use computer programs to automatically match up traders with buy and sell orders for many NYSE-listed stocks.

So what's the verdict? Essentially, a tie. Overall, both the NYSE and the

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electronic systems did their jobs. Both played key roles in piloting Merck's badly damaged stock to a relatively smooth emergency landing. The electronic exchange helped take down the price before the NYSE opened. And the NYSE completed the job with huge block trades throughout the day. Despite trading more than 144 million shares -- 20 times the normal daily volume -- volatility was essentially kept in check after a quick 27% plunge gobbled up \$27 billion in market capitalization. The shares, after closing at \$45.07 the night before, opened on the NYSE at 9:32 a.m. at \$33 each and traded in a remarkably tight range of \$32.46 to \$34.02 for the next seven hours, before closing right back at \$33.

The performance was so good that John A. Thain, CEO of the NYSE, is touting it as evidence of the superiority of the exchange's system of floor auctions. "The specialist was able to find a price that was fair for both the buyers and the sellers, which is what led to the market being fair and orderly," says Thain. In the opening trade, the specialist assigned to Merck, James J. Barry of LaBranche & Co., matched up buyers and sellers of 5.7 million shares. He bought about 10% of those shares himself for LaBranche, helping make up for a shortage of buy orders, according to the NYSE.

But the two big electronic systems, Archipelago Exchange and INET, say they also deserve credit for finding the \$33 level that satisfied so many buyers and sellers and opened the way for the flood of trades. Indeed, the ECNs, already open when Merck broke the news, were the first responders. They traded about 10 million shares before the NYSE opened, walking the price down through small trades to the NYSE opening price. Archipelago President Michael A. Cormack believes key electronic trades came from savvy investors who knew Merck well enough to figure out it was worth about \$33 without Vioxx. "Our clients essentially discovered the price long before the (NYSE) specialist became involved," he says.

Not surprisingly, Thain doesn't see it that way. He argues the specialist's ability to choose \$33 as the opening price came from much bigger orders queuing up on the NYSE floor. But the pattern of steadily declining prices on trades that Archipelago posted to the public before the NYSE opened shows the electronic system was important. Those early trades helped chart the course for the stock price and the big volume that followed.

The NYSE rivals handled 35% of the shares and dollar value of Merck trading for the day, almost double their usual 20% share of the volume in NYSE-listed issues. That's because when stocks are under the stress of sudden news, buyers and sellers tend to turn to the electronic systems to quickly buy and sell in smaller volumes. "People crave electronic markets when things get tough," says Cormack.

Still, the NYSE carried the big loads. The average trade on the NYSE for the day was 11,000 shares, more than twice that on Archipelago, according to the NYSE. Amid that pressure, the NYSE specialist kept the average spread between bid and ask prices, a key measure of trading costs, down to just 3 cents. While both sides want to claim victory, the day showed that investors aren't best served by one system or the other. They're best served by having both.

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Wall Street Journal

January 31 – February 1, 2015

NYSE Group Planning Midday Auction for Its Stock Markets

New Auction Seen as Draw for Big Investors to Trade Blocks of Stock

By
Bradley Hope

The New York Stock Exchange plans to ask regulators for permission to introduce a midday auction as another tool to draw trading away from private venues such as dark pools, according to people familiar with the matter.

Both the NYSE Group, which is owned by Intercontinental Exchange Inc., and Nasdaq OMX Group Inc. already operate an opening and a closing auction for their markets.

The new NYSE auction would take place in the middle of the day, when trading is at its slowest. One draw of such auctions is they allow big investors to put in large orders without immediately moving the price of a stock, the people said.

Auctions work differently than continuous trading on markets, which match orders as they come in at an ultrafast pace. In an auction, buyers put in a maximum price and quantity they are seeking to fill and sellers put in a minimum price and size they are willing to sell over a period of time. At the end of the period, orders are filled at a price set by supply and demand for shares.

NYSE is expected soon to file a request to introduce the midday auction, but the system wouldn't be set up until later, they said.

THE WALL STREET JOURNAL

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Traders Warn of Market Cracks

By TOM LAURICELLA And GREGORY ZUCKERMAN

Amid the wild swings of the past few weeks, cracks are appearing deep in the workings of the stock market that some professional investors say are making the market treacherous to trade.

Hedge-fund traders and mutual-fund managers say it has become increasingly tough to trade an individual stock without causing a big swing in its price. That's led many large investors to step back from the market instead of risking being stung by the trading difficulties.

The big moves in stock indexes have caught attention. Just on Monday, the Dow Jones Industrial Average dropped 247.49 points, or 2.13%, to 11397.00. But market participants say trading conditions are much worse when they drill down to individual stocks, highlighting skittishness of investors of all stripes.

Even among some of Wall Street's most actively traded stocks, such as Apple Inc. or Netflix Inc., traders say it has been more challenging than usual to buy or sell.

The problem is a lack of liquidity—a term that refers to the ease of getting a trade done at an acceptable price.

Markets depend on there being many offers to buy and sell a particular stock, across a range of prices. But as investors have gotten nervous, many of those offers have dried up. That is causing wider-than-normal gaps between prices showing where stocks can be bought and where they can be sold—the difference between the "bid" price and the "ask" price.

Many big investors, such as hedge funds and mutual funds, which at times can act as shock absorbers for trading because they tend to trade large chunks of stocks, have been on the sidelines. Some hedge funds, for example, say they're not trading as much until they know how much money their clients will withdraw at the end of October, a deadline some clients have to inform funds of intentions to redeem money at year-end.

Wall Street firms and banks, meanwhile, have significantly less appetite for taking on the risk of holding whatever it is that clients are buying or selling.

Some analysts and investors say poor liquidity and market turbulence, which has seen the Dow rise or fall by 1% or more in 14 of the past 19 trading days, will continue as long as government officials squabble on both sides of the pond, banks and others look to reduce trading risk and the global economy stays on a shaky footing.

In some ways, investors would be expected to leave the market in uncertain times, but traders say the exodus of late is striking and underscores the nervousness of market participants, and the lack of willingness of many to step in to trade.

"Liquidity will continue to be a big problem," says Patrick McMahon, co-founder of hedge fund MKP Capital. Mr. McMahon says he has noted the sharp decline in liquidity, or market depth, in recent months. And, with global banks reducing their risk exposure, they are less likely to step in and take either side of trades, Mr. McMahon says.

He says fewer investors are willing to buy or sell stocks, creating an effective vacuum.

"That's why you get 5% moves in a matter of minutes," he says. "When there are sellers, there are few buyers, creating an air pocket down."

And it's not just stock markets. Liquidity has also been sucked out of credit markets, too, traders say, from corporate bonds to mortgage-backed securities. Global banks have been reducing their exposure to riskier bonds and are less likely to step in and take either side of bond trades, Mr. McMahon says. In some cases this is spilling into the stock market, as debt investors scramble to trade there.

"Any reasonable sized selling is driving individual bond prices down quite a bit," says Jeffrey Kronthal, co-founder of hedge fund KLS Diversified in New York, who says bid-offer spreads in areas such as some residential and commercial mortgage-backed securities have more than doubled in the past month or so. "Really, no dealers are putting up capital. A lot of stuff just doesn't trade."

In the stock market, one well-known manager of a large hedge fund said he recently tried to buy \$250 million of shares of Tempur-Pedic International Inc., a mattress maker with a nearly \$4 billion market value. The manager, who declined to speak on the record, says he gave up after his initial order of \$20 million of shares pushed prices of the stock up too far.

"You try to get something done at one level, and if you take your eye off the screen, it can move to the next level," says David Schiff, deputy head of equity trading at JPMorgan Asset Management. "There's not a lot of depth at any price point."

To some degree there's a chicken and egg phenomenon at work. As poor liquidity begets more volatility, big investors and brokerage firms become even more wary of being active in the market. And individual investors, many of whom are out of market already, are less likely to return. Volumes, while erratic, have largely been lower in recent weeks. Some 3.7 billion shares changed hands in New York Stock Exchange composite trading on Monday, compared with this year's average of 4.4 billion.

Some traders say this kind of dynamic is what should be expected for such highly uncertain times.

"Yeah, of course it's harder to trade," the head of one mutual fund trading desk says. "You can't do things you used to be able to do four months ago, but it's a different market."

The best way to judge liquidity, some traders say, is by looking at the bid-ask spreads.

For the stocks in the Standard & Poor's 500 stock-index, spreads have been at their widest since late 2009, when markets were finally calming down from the worst of the financial crisis. The median spread on S&P 500 stocks on some days topped 0.05% of their share price on multiple

days, up from an average of just over 0.03% for the first seven months of 2011, according to Credit Suisse's AES electronic trading group.

The lack of liquidity can also be seen in the spreads among actively traded stocks. On Apple, for example, the average spread has on many days been double what it was back in June, according to data compiled by T3 Trading Group. On shares of Amazon, the spread has gone from 0.03% of the share price to a spread of over 0.05% in recent weeks. The spread on Netflix shares widened to over 0.07% in September and early October from 0.05% in late June and July.

One surprising element of the fall-off in liquidity is that one key set of players actually appears to be more active in recent months: so-called high-frequency traders. These hedge funds use computer models to trade at a rapid pace. In recent years they have replaced brokerage firms as the go-betweens when investors trade stocks.

But with so many other players stepping back from the market, the liquidity that high frequency traders are providing isn't creating much of a cushion, traders say. In fact, some say they may be making matters worse.

Conditions have improved a bit over the past two weeks, says Scott Redler, chief strategic officer at T3 Trading, but overall, trading in stock such as these have "felt thinner and it's hard to get good executions. As soon as you get filled, it feels like the prices are against you."

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Mind the Gap

The spread, or percentage difference between the price investors are willing to buy and sell a stock, grows as markets become more volatile.

