

Corporation 20/20 Luncheon

“Is Corporate Ownership Dissolving? High-frequency trading and what it means for the movement to bring the casino economy back to reality.”

*Discussion led by John Katovich, chief regulator with NASDAQ'S Boston Options Exchange Regulation, and Marjorie Kelly, co-founder Corporation 20/20.
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High-frequency trading, trading equity at tens of thousands of times per second, now represents over two-thirds of all stock trading in the U.S. The single firm of Getco buys and sells 15 percent of all shares trading today. What does it mean for corporate ownership? For proxy voting? For the notion that boards represent "owners"? If traditional equity ownership is dissolving, what can take its place? Is there an opening here for a strategic move by social investors, one that favors long-term investors over short-term speculators? For background reading, a Forbes article, "The New Masters of Wall Street," was distributed beforehand.

<http://www.forbes.com/forbes/2009/0921/revolutionaries-stocks-getco-new-masters-of-wall-street.html>

On hand the day of the discussion were copies of an SEC concept release, requesting public input for a “broad review of the current equity market structure” the agency is beginning, including an assessment of whether market rules have kept pace with changes in technology and practices. The group discussed the possibility of drafting a comment for the SEC. Comments are due April 21, 2010. See the Concept Release on Equity Market Structure at www.sec.gov/rules/concept/2010/34-61358.pdf

After a welcome by Allen White, director of Corporation 20/20, Marjorie Kelly opened with brief remarks on the nature of ownership. It's one of the oldest economic concepts in the Anglo-Saxon tradition, dating back 10,000 years to the advent of the agricultural revolution, when humans ended nomadic wandering and began a permanent relationship to the land. Ownership was at issue in the writing of the Magna Carta over 300 years ago, when barons told the king they would no longer hold land at its pleasure but would own it permanently. As economic historian Gar Alperovitz has written:

“The truly defining characteristic of any political-economic system centers always on the issue of property: in the feudal era, massive land ownership was central to who had power. In 19th-century capitalism, modest-size enterprise ownership (of farms as well as businesses) was central. In modern capitalism, corporate and elite ownership is key. In socialism, state ownership is the hallmark.”

Today, company ownership is evolving in unexpected new ways with high-frequency trading (HFT), which is accelerating a trend to short-term company ownership that has been in process for decades. We are moving from a world where ownership represents an intimate and permanent relationship to a company to a world of transiency. Ownership, in high-frequency trading, is almost a parody. Is there a chance to reclaim the notion of ownership? Linguists like George Lakoff would say it is a powerful, deep linguistic structure that serves as a legitimating force in our culture. Can we begin to draw a bright line between real ownership and speculation? What would happen, for example, if voting rights on equity shares were extended only to shareholders who had held shares for one year or more? This is a suggestion that has been made by Paul Volcker. Could this potentially give more clout to responsible investors?

John Katovich followed with remarks on the role of markets and the advent of HFT. The primary role of markets is to efficiently allow for the transfer of savings toward ownership, in order to

allocate capital for companies to produce products and undertake research and development. Secondary roles include lowering the cost of exchanging ownership rights, helping investors diversify, and providing liquid means of sharing risks.

Markets have become something very different today. Initial public offerings (IPOs) – where companies raise funds by selling shares into public markets – have declined, for example.

- Between 1961 –1969, each year saw between 500 to over 1000 companies going public.
- 1974-'79 – 50 or fewer companies went public each year.
- 1980s – 150 to 500 went public each year, with the exception of 1983 which saw 900 again.
- **Recent Activity – 2006 – 238; 2007 – 296; 2008 – 57; 2009 – 25 (est.)**

Brokers are now selling other products – options, futures, debt, EFTs, etc. Because of the shrinking margins of doing an IPO, investment banks are more and more moving toward merchant banking. There is much more profit in financial engineering and high-frequency proprietary trading, than in IPO work. Fewer shares are now owned by individuals. In 1950 – individuals owned 90% of shares. In 1980 – 70%; In 1995 – 50%. The number is even lower today.

July 24, 1996, Report of the Advisory Committee on the Capital Formation and Regulatory Process – the “U.S. capital markets have shifted – on a relative basis – from a primary role as a source of capital to a venue predominately for secondary trading. The secondary trading markets for common equity have grown exponentially in comparison to the primary issuance market, with over \$5,500 billion in secondary trading versus \$155 billion in primary issuances in 1995. (2%) The registered primary issuance market for common stock has remained relatively stagnant as a source of capital since 1933.”

Today, Less than 1% of trades involve investors buying stocks just issued by companies. More than 99 percent of all stock trading is in the secondary market. Yet the dollar volume of financial trading has increased nearly forty-fold since the 1960s. Adjusting for inflation – the increase in market value from 1982 to 2000 was approximately 343%. Size of the U.S. equities market today is approximately \$23 trillion. In 1982, daily trading volume was 100 million shares. Today, daily volumes are 6 to 7 billion. The number of trades increased 670% from 2005 to 2009.

HFT accounts for approximately 70% of the volume today. Only about 2% of U.S. trading firms employ high-frequency trading; the top 3 HFT Firms account for half of the 70% of volume. One firm boasts of the ability to issue 100,000 trades per second. It is estimated that of all trades sent out by HFT firms, 90% of orders are cancelled – they are issued as a technique to see where prices are moving, what prices are acceptable to buyers, and to find the other pools of liquidity.

Between June 2007 and November 2008, it has been reported that Americans lost more than a quarter of their net worth. Taken together, these losses total a staggering \$8.3 trillion. In 2008, the Big 3 HFT Firms made \$55 Billion profit. In 2009 – Big 3 HFT firms made \$180-200 Billion profit; All HFT firms combined may be estimated to have made profits of over \$1 Trillion in 2009.

Why does high-frequency trading matter? In general, it diminishes the connection between investors and companies, making equity ownership more ephemeral, more short-term, less likely to lead to a long-term responsible relationship between companies and their so-called owners. It puts the entire system more on autopilot. It may make social and environmental engagement with

companies more difficult, because the tenure of ownership is so abbreviated that it ceases to constitute a real human relationship. More immediately, there are two key risks – systemic risk, and the risk of market manipulation. Even Adam Smith cautioned about this. Beware the Prodigals and Projectors – the promoters of excessive risk in search of higher profits. HFT introduces huge risk and instability. Computerized trading systems can also create havoc (as happened in 1987), because trades can be fast enough and large enough to create a market-crashing event.

Also, nonfinancial companies are now modeling their behavior on financial companies. Investors and managers are saying, why can't they/we make the same returns as financial companies? This is where it bleeds into being dangerous to us all.

The group discussed three questions:

1. What's the difference between ownership and speculation?
2. How does HFT accelerate the drift toward speculation?
3. What are the social consequences and possible remedies?

One person commented that instability is the real problem. The invisible hand does not work for financial markets. They do not naturally come to equilibrium but require the intervention of regulators. The machinery is built to explode. It needs an engineer. You don't run trains without engineers. We ought not run financial markets without regulators.

An investor commented that the problem is not speed but frequency, as it relates to the length of ownership. Hedge funds can have ownership in a company's stock that is leveraged three times – they own three times more stock than they have a right to, because it's borrowed money. And at the same time, they can be shorting that stock (betting it will decline in value), and going long in the stock (betting it will rise in value). How do you define ownership? Hedge funds got together and bought enough shares in the Deutsche Bourse stock exchange to remove the chairman and senior management, because they thought he would interfere with their trading strategies.

Another problem is that a bloated financial sector distorts the expectations of people in the educational system. A number of math professors left SUNY Stonybrook to get involved in financial trading. One later gave a \$20 million Christmas gift to the math department. There aren't too many math professors making \$20 million gifts to the math department. Another recounted the article of the neuroscience PhD student who, after the financial meltdown, was now thinking he would have to go back into his field of study since he may not find a job on Wall Street. Non-financial fields of study can seem diminished, in contrast to going into the financial sector.

There are intangible distortions from the giant sucking action of financial markets. It distorts the educational system, individual aspirations, and models of management.

An attorney commented that if speed changes the nature of fiduciary responsibility, this can itself create significant problems. There have been structures in place for hundreds of years to control and restrict speculation. In an 1831 Massachusetts court case, concerning the prudent man rule, investments in common stock were permitted as long as they were long term and not speculative. In another case, *Tratford v. Boehm* (check spelling), in 1743, the House of Lords held that investing for fiduciary purposes in anything other than annuities or the Bank of England and

South Sea Company violated fiduciary duty. Speculation has been a problem since the 1600s. We have to continually go back and address it.

One person suggested, why not impose a capital gains tax of 99% on any shares held less than one day? A confiscatory capital gains tax.

You can't really eliminate speculation, it was commented. Keynes noted that speculation is no problem if it is a bubble on a pool of productive enterprise. But when enterprise becomes a bubble on speculation, you're in trouble.

The group discussed alternative ways for people to own shares. One suggestion was the creation of two markets, one for speculation, one for long-term ownership, where companies decide which they want their shares listed on (one or the other but not both). In the long-term market, there could be various rules – such as, when you buy stock, you can't sell it for a certain period of time (e.g. two years), and there would be no shorting.

Another solution discussed was Volcker's suggestion of limiting voting rights to shares held one year or longer. There are some companies in Europe that give twice the voting rights to long-term shareholders. In Brazil, there are two parallel exchanges, one focused on good governance. The concept of dual exchanges is already in play.

The notion of creating two markets could also be applied at the product or firm level. A special class of shares could be issued with no voting rights. If shares were held for under a certain period of time, they must be of that class. There could be multiple classes with different voting rights. Here again, there is precedence in the dual-class shares issued by firms like New York Times, Interface, and Washington Post, where one class has greater voting rights than another class. Dividends might also be different, with no dividends paid to speculative shares.

Another commenter raised the concern of the growing financial economy now skewing traditional views of economic health. For example, the massive growth of the financial industry is a deceptive but significant aspect of GDP, which is still used to gauge the health of the economy, and to predict growth, jobs, etc. If the financial economy continues to push up the GDP, yet it contributes little to other factors such as employment and production, do we need new metrics now to assess our financial health?

Do we actually need trading throughout the day? What if we could only trade 20 times a day (separate auctions throughout the trading day)? Wouldn't that be sufficient liquidity?

Keynes said, to make a transaction long term, entering it needs to be equivalent to entering a marriage.

Pension funds should be forbidden to go into speculative markets. There was a 1984 ballot initiative in California that allowed pension funds to invest more than 25% of assets in stock. Prior to that, they were not allowed to be hugely invested in the stock market. We could put such rules in place again.

Are there laws on which we can hang our recommendations? The securities laws on the books now favor disclosure. If we can tie into that mission, suggestions might be well received. The securities laws were originally meant to be expansive but were narrowed in recent decades.

We might use, as our fundamental frame, that we need to draw a bright line between ownership and speculation. Does investing today really represent ownership? If not, what does that mean? If we all agree it is damaging to the economy and the planet to have lost real ownership, how can we begin to restore the concept of ownership to its rightful place?