Editorial Board

Slowing Down the Stock Market

Replacing the 24-hour, continuous trading of stocks with frequent batch auctions could help investors and the market.

By Editorial Board
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Can more batch auctions cure what ails the U.S. stock market?

Many a fortune has been won (and lost) in the U.S. stock market. The market's primary purpose, though, is not to dispense riches but to serve the public good by allocating capital to the best uses -- to the ideas most likely to drive sales, earn profits and reward shareholders.

Today's stock market is falling short. A wasteful arms race among high-frequency traders, the growth of dark pools (private trading venues) and assorted conflicts of interest have undermined its performance. If investors don't trust the market, that hurts capital formation, not to mention retirement and college savings. The number of Americans who own stock directly or through mutual funds is at a 12-year low -- a sign that individual investors think the market isn't for them.

Fixing the problems will require more than a tweak here and there. One idea that's winning converts would replace the 24-hour, continuous trading of stocks with frequent auctions at regular intervals.

Why would that help? Because it would lessen the emphasis on speed and direct more attention to the price that investors are willing to pay for stocks, given the prospects of the companies concerned, their industries and the broader economy. The high-speed arms race would subside, because shaving another millisecond off the time it takes to trade would confer no benefit.

The idea has a good pedigree. It has been around at least since 1960, when Milton Friedman proposed a version for the sale of U.S. Treasury bonds. Researchers led by the University of Chicago's Eric Budish refined the concept in a paper last year.

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Under their system, orders would be sent to the exchanges, as they are now, but instead of being processed immediately, they'd be collected into batches, based on when they arrived at the exchange. A computer would then use an algorithm to match the orders. Auctions would take place at least every second (for 23,400 auctions per day, per stock), matching supply with demand at the midpoint, or the uniform price. Orders that don't get matched -- either because they exceeded the volume of shares available or because their buy or sell quotes didn't conform to the uniform price -- would automatically be included in the next auction.

As well as prioritizing price over speed, this approach would make another flash crash less likely. That's because it would stem the flood of buy, sell and cancel commands that high-frequency traders issue every second in their efforts to probe the market.

Auctions would also reduce the need for dark pools, because the orders of institutional investors wouldn't be visible to other participants. The fear among big investors such as mutual funds --

that placing an order will move the price against them -- is the reason dark pools caught on in the first place. The result should be lower transaction costs and higher investment returns for 401(k) owners and other savers.

The conflicts of interest that brokers now face when they send orders to the trading venue that pays them the highest rebate or fee, rather than the one that offers the best execution, would recede as well. That's a good thing. Brokers who put their own financial interests above their clients' are violating a duty to get them the best price.

Goldman Sachs Group Inc., among others, is interested enough in frequent batch auctions that it's working with Budish to find an exchange that will conduct a pilot program and a regulatory agency that will monitor the results. Mary Jo White, the Securities and Exchange Commission chair, indicated in a June 5 speech her interest in batch auctions. She should make it a priority to conduct a test program. It's a promising idea.

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