

Market Structure

Key Words for IRO's Lexicon

Reg NMS Means IROs Must Really Understand Their Market Structure

BY TIM QUAST

Under the new algorithmic order evolving rapidly in today's global equity markets, investor relations officers should add two more key words to their IR lexicon: *market structure*.

Let's begin by defining "market structure" this way: Consider the pattern formed by the number, size and distribution of buyers and sellers in a market. With the major stock exchanges now essentially becoming leading Electronic Communication Networks (ECNs), equity markets are being driven today by *participants* rather than the former and familiar "auction establishments" (of which, NASDAQ now owns BRUT and Instinet; NYSE has absorbed Archipelago).

Proliferating alternative trading platforms — such as EBX, EdgeTrade, NexTrade, NYFIX, Octeg, and BATS Trading — are also electronic and automated, and their architecture is designed to address the liquidity requirements characterized by fast and mostly anonymous trading.

With equity markets structure so radically different than just a few years or even months ago, IROs could be in danger of becoming an anachronistic participant if they rely on old tools and old rules for this new and different game.

Consider the impact of the SEC's Regulation National Market System — Reg NMS — in effect since March 5, 2007. Ostensibly, this nascent rule for broker-dealers enhances fair competition for

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market participants. In practice, NMS benefits trading systems seeking *alpha* — divergences from norms — at the expense of the capital appreciation that fundamental investors have long sought.

How? Because, by design or default, the new environment makes for a difficult place to find good supply/demand economics if your method for participating in the market does not involve very sophisticated mathematics. Let's use an analogy: Suppose you went to the store to buy potatoes, and instead of finding a certain amount of potatoes at a certain cost, the prices of the potato bin was constantly fluctuating. And, conveyor belts running in and out of the bin were taking and leaving potatoes for your choice at astounding speeds. And no potatoes were available by the bag.

If you wanted ten pounds of potatoes, what price would you actually pay for them? How much time would it take to accumulate your ten-pound potato position if you had to pay for one potato at a time with your ATM, with trips to and from the checkout counter as you accessed supply? Would you at some point throw up your hands in exasperation and either find a different market (that's private equity) or run your own conveyor belt into the bin (that's direct access)?



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This is in effect what Fidelity and other large, formerly fundamental investors have done. With market structure and regulation pushing participants relentlessly toward quantitative participation, three facts emerge:

(1) The buy-side and sell-side have, on a wholesale scale, developed or adopted sophisticated algorithmic platforms to address inefficiencies stemming from market fragmentation.

(2) As a result, public equity markets now are driven by execution platforms seeking alpha that absorb liquidity and reduce the opportunities for capital appreciation that fundamental investors seek.

(3) These factors play a significant role in determining whether the messages that IROs articulate on investment thesis will in fact continue to bear fruit through targeting.

What's an IRO to do? First, we must accept that market structure really does matter and that traders and investors alike act on its basis. Second, learn your market structure by examining your company's market participants and understanding which factors drive high-frequency trading, programs, arbitrage, rational execution, and so on. (Tools do exist for these purposes.)

Where to start? Get to know a trader or two responsible at their firms for your equity. Explain that you'd like to understand how programs, arbitrage, derivatives, structured products and high-frequency trading impact your stock, and would he or she provide some education? We humans enjoy talking about what we know.

Then, you can decide to what degree you wish to use this new knowledge for shaping your IR strategy and raising the profile of IR at the management table.

Sure, all of us old-school IR veterans — even those of us now engaged in trading intelligence — would like to continue to believe that corporate strategies are the chief arbiters of value. But to quote Nicolas Cage's character from the movie "City of Angels," "...some things are true whether you believe them or not."

There is ironic good news here for IROs: Like anything else, once you understand the algorithmic nature of your market structure, you can make adjustments in your practice of IR that will continue to enhance your shareholders' interests. Math is fragile and finely balanced.

Lastly, there's investment involved in acquiring new skills and knowledge, so what's the return, IROs? You'll spend less time and money on information that no longer matters under Reg NMS. Your knowledge of what influences share values will be more precise and accurate. And your worth, both at the management table and in the IR chair, will be that much greater. IRU

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BREAKING NEWS, ON DEADLINE...

"THIS JUST IN..." AS THE EDITORS CLOSE THE ISSUE, THIS NEWS CAME TO OUR ATTENTION.

PR Newswire's Disclosure Advisory Board Issues Second White Paper for IROs

PR Newswire has assembled a 15-person council of leaders from the corporate, regulatory, investor, reporting, and academic communities to serve as its Disclosure Advisory Board, a number of whom are NIRI members. The Board has just made its 2007 recommendations its second white paper — "Shareholder Identification — The Resounding Silence of Non-Disclosure." The Advisory Board's first white paper was titled: "Guiding Investors and Analysts: How Much Information is Enough?"

The primary message from the just completed report is: "In an era of unprecedented corporate disclosure requirements, investors with hidden identities — and sometimes hidden agendas — are participating in the U.S. capital markets. Trading beyond the reach of regulations, these investors conceal their identities from other market participants as well as corporate issuers. When those with hidden agendas "uncloak" and make their intentions known, market chaos may prevail."

White paper highlights include:

- Undisclosed shareholder syndrome most prevalent in U.S.; almost a complete absence of shareholder disclosure in U.S. compared to other sophisticated markets; unfair and unenviable.
- Emerging global standards for shareholder disclosure (U.K., France, Australia, South Africa) paving the way for change.
- Paradoxes pushing for **change** — Foreign issuers can find out more about their U.S. investors than U.S. issuers can find out about U.S. investors. U.S. issuers (because of local market regulations) can find out more about their international shareholders than their U.S. ones. Investors abroad know the identity of other investors in the markets; however when these foreign investors invest in the US market, they give up this kind of insight.
- How to resolve the situation — Time for shareholders to disclose their identity; a little *quid pro quo* in order. (Specific recommendations are offered.)

Conclusions — Next Steps

- Important to act now: issues affect entire market, all players, and U.S. financial market leadership.
- Additional calls to action: comment on the transparency matters blog; e-mail the board.

The just-completed white paper contains specific recommendations for IROs and will be available at the PR Newswire booth at the NIRI National Conference in Orlando.

Details will be provided in the July issue of *IR Update*.