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Sociology of Wall Street

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The battle and co-constitution between financial market participants and regulations

Market participants and regulations generally co-constitute the market, through formal and informal restraints and social constructions. However, if powerful enough, participants can bend regulations in their favor. Powerful firms are often under the scrutiny of regulations but sometimes they support the implementation of new regulations because it improves their market share and disadvantages their competitors. In other words, they are not always against being regulated by central forces. Regulations are a necessary component in markets because newly introduced technologies and innovations always make people look for loopholes to exploit and extract profit. This paper will look at various cases of how participants and regulations interact with each other.

With technology and regulations constantly changing, corporations search for gray areas they can capitalize on. For instance, Salomon Brothers bought 94% of the treasury bonds and sold them to others at higher prices, squeezing their contenders. This was not exactly illegal at the time and participants of such activities claimed that their practices are legitimate because most firms were doing it, offsetting the differences in prices generated by cornering other firms. However, it appeared that fair competition was impossible as some companies just had more assets, networks, and information. Eventually, the SEC ruled this process illegal and fined Salomon Brothers 290 million dollars. In this exchange between the market participants in the cornering process and the SEC, they are directly at odds. The regulators won here and the public would generally argue that this created a more fair market for trade. This is how regulations dictated the market on its own. However, the power of the regulators is limited as well. They are expected to only act in ways that would maintain or improve the market.

The revolving doors in the finance sector are well known. Someone who spent years in investment banking, futures, or bonds may change jobs and move into a regulator position later and this raises suspicions that they would use the information they know or lobby or be lobbied by others. Insider trading is traders using nonpublic or confidential information in their interests and is clearly illegal. The case revolving doors would definitely fit under this category as they have the undisclosed information they may be able to exploit. Although many argue that when people change their jobs, they enter different sectors or fields away from financial markets but this is only a partial story and many in fact go from public to private and back, which creates a fallacy in the logic and ethics for regulators. The regulators lose their rationale of keeping the market clean and fair for all participants if their self-interest is under influence. If people are aware that some would benefit more from the regulations they set, then they would question the legitimacy of the regulations set by the exact same people and eventually, both the formal and informal restraints will have less power over market participants.

Next, we will look at high-frequency trading (HFT) and its battles with regulators. With the introduction of electronic trading and HFT, speed became a key component in the competition. HFT firms sought chances for latency or slow-market arbitrage and frontrunning. Many participants in and out of HFT trades found such speed wars to be morally questionable claiming that large firms were gaining an unfair advantage against smaller firms or individual investors and also was doing harm to the market. In short, they believed HFT has essentially legalized frontrunning. They also claimed that the liquidity they provide was only based on market volatility and that the liquidity disappeared when it is needed or was to be executed. The

SEC was investigating them for possible illegal activities like spoofing or frontrunning but could not prove anything, so HFT only remains with a questionable legitimacy but is not condemned as illegal. Similarly, dark pools are where stocks are traded privately without immediate disclosure to the public. Through keeping information private, they can freely trade without price responding to their large buy or sell. Their major risk is that due to the low volume of market makers, they have more uncertainty in execution. Dark pools were controversial too because they also provide uneven advantages to large institutions. This is problematic because only a small proportion of trade is public and others are from off-exchange wholesalers and a few giant firms, which would also accelerate income inequality and fall in equity levels. As HFT activities generally do, dark pools also increase market volatility, which is why people suspect that they have a negative influence on the market.

To combat HFT, the Intercontinental Exchange (ICE) and IEX added speed bumps to deter their speed. Later, IEX particularly created a new speed limit called D-Limit which detects crumbling order quotes due to excessive taking, and stops order books from emptying, essentially stopping HFT terms from taking such a large market share. In response, most HFT firms naturally tried to rule speed bumps illegitimate to disable the implementation of D-Limit because it would take away their profit and position in the market. For instance, Citadel, the biggest HFT firm at that time, sued the SEC for ruling D-Limit legal, and Citadel was supported by Nasdaq who also had motivations to maintain the profitability of HFT. On the other hand, firms like Virtu, Goldman Sachs, and Vanguard supported the SEC and IEX, or the D-Limit they were promoting. As we see in the case of D-Limit, powerful corporations fight over critical factors, shaping ideas about what is legitimate and illegitimate. Once this norm is established, firms divide various practices in three categories. Legal and legitimate, legal but illegitimate, and illegal and illegitimate.

The case to look at next is payment for order flow (PFOF), which is deemed illegitimate by some market participants while its supporters claim that they provide finance to middle and working-class people. PFOF has gained huge popularity over the years, with Robinhood and Gamestop being a few examples. For PFOF, the wholesalers do not have to go through public exchanges to trade but rather can internalize the process if liquidity is high enough. However, the main criticisms of PFOF arise when the trades are not internalized but instead are taken into dark pools and alternative exchanges for cheaper prices which they sell to their clients at slightly higher prices. While this is not illegal, the retailers are not acting in the best interests of their clients, which people find illegitimate. For that reason, a few countries such as Canada, U.K., and Australia have banned PFOF. SEC in the U.S. are considering following their decisions but PFOF has not been banned in the U.S. for now with its supporters fighting against a ban.

Brad Katsuyama, the founder of IEX argued that exchanges should fairly price for both slower and faster participants and provide lower fees for listing companies compared to Nasdaq or NYSE, all the while calling the existing market rigged. His calling out for the unfairness raised backlash from exchanges and incumbent firms that the market is never perfectly fair nor it should be. HFT firms claim that they only have a bad reputation and public image due to the public not correctly understanding their mechanisms and business model, and also assert that unfairness is part of the free market and is everywhere in a capitalist society, being a defining factor for financial freedom in America. The arguments go on back to back and become very political. Enormous assets are at stake and people in the finance sector are typically trained to be rational, sometimes even hyperrational when rewards are immediate while fairness is theoretical and do not generate high profit, which is not surprisingly what people at wall street all aim for, and this makes equity a difficult goal for a free market.

Furthermore, market participants institutionalized ideas using moral bifurcation (Knight 2018), legitimizing making as providing market liquidity and illegitimizing taking as taking liquidity out of the market, to improve public relations for HFT despite being partial. This created a binary choice for people to believe in, that one is morally superior when both in fact have the same purposes and ethics. While Michael Lewis (2014) argues that the term liquidity is being misused by the HFT firms because they are not taking any market risk, the firms claim that their activities make the bid-ask spreads decline, making the prices more efficient. Their debate about liquidity did not shift public opinion so much, and thus liquidity remains synonymous with volume, and the public was eventually convinced that making was good and taking was bad. In addition, firms were specialized in their work, meaning that firms that focused on making did not take much part in taking, and vice versa. As a result, firms that mainly did taking were condemned both in and out of the industry which was problematic for the taking HFT firms that were striving for better public relations.

On the other hand, Abolafia (1996) argues that "market participants [are who] that reshape the institutions (Abolafia 9) as opportunism and restraints tend to come from embeddedness in social situations and conditions, and rather not from psychology or logical efficiency demands. All participants in the market have different levels of tolerance for opportunism and restraint and that level is determined by their group's "social relationships and cultural definitions" (10). This in turn explains why the regulations different groups attest to are not the same and where their conflicts arise. When some participants act in their interest to a degree that harms others' interests, they are pressured and then regulated to restrain their opportunism, and as a response to the lowered level of opportunism occurring, regulation drops to its previous level, which is what Abolafia refers to as “cycles of opportunism” (11). It is also a common misunderstanding that people’s biggest interests lie in accumulating assets, but it is rather the social status and the symbols of wealth and power they attest to. It is important to note that there are informal restraints as well, which are not formalized regulations but tacit understandings among buyers and sellers. This was rampant in the bond trading markets where they had little information and interaction between the traders and thereby not creating trust or embeddedness in social relationships. Informal restraints were more prominent in stock exchanges and future trades because they generally required more trust and ongoing relationships between participants, but had relatively less impact in the bond market as informal restraints were more volatile from political influences. One may assume that informal restraints are not that strong, but they constitute the market through institutionalized rules and cultural interpretations.

As we have seen with Reg NMS, speed bumps, D-Limit, and policies that ruled spoofing, frontrunning, and cornering–squeezing other market participants through purchasing the majority of certain treasury bonds–which have been ruled illegal were all based on regulations that emerged to keep markets stable, fair, and healthy. Without these regulations, HFT may have wiped out slower trades and wealthy investors may have used market manipulation as a strategy to beat their competitors. But as mentioned, the regulators who design these rules are also from the same industry with the same flaws and people, and after they have influenced the regulations they once again go through the revolving door and take advantage of that regulation. This gives more power to the giant firms at the expense of equity and even distribution. In addition, firms also lobby the SEC and other controlling institutions to their favor, giving the firms even more power to shape the regulations. Whether which parties have more power matters greatly because regulations are instituted by the powerful and have the corresponding amount of authority for the influence and reputation they have. Thus the market participants powerful enough will have some control over regulations and while the established rules will help facilitate the market it will sometimes fail to regulate the most powerful participants.