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Best Executive in Securities Markets: An Application of Signaling and Agency Theory:
Discussion

Author(s): S. Smidt

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Turning to somewhat more specific issues, Professor Houthakker's discussion of position limits does not include consideration of the possibility and wisdom of requiring fuller public disclosure of positions, or of the distribution of open interest as maturity approaches. Exchanges have not customarily disclosed this information to traders, although some regulators have proposed just such disclosure as a remedy to corners and squeezes.³

With respect to the solvency of Clearing Houses, I agree that we have a very vague understanding of what the important issues are and of the benefits and costs associated with alternative types of solvency regulations. I would go further than Professor Houthakker does, however, and argue that price limits should probably be eliminated, even if this were to necessitate higher variation margins. Clearing Houses are obviously an important institution and should be given additional thought and scrutiny.

An issue about which he and I are in greater disagreement is the regulation of off-exchange contracts. At times he seems to be saying that there should be regulation of off-exchange instruments only where there has been fraud, and no regulation "where no allegation of fraud could be made." Needless to say, I do not see his logic here. In my view both exchange and off-exchange instruments which are in some meaningful sense substitutes for one another should be subject to identical regulation. Can it be otherwise and have both co-exist for long? Whether off-exchange instruments should be more regulated than at present or exchange instruments less regulated than at present is a separate issue. Whatever the right dose of regulation, it should be administered to both equally.

Finally, I am dubious about (or at least perplexed by) Professor Houthakker's synthesizing statement about the difference between financial futures contracts and other futures contracts. He says: "There is really only one difference and it is merely a difference of degree: financial futures are more important from a policy point of view." This view seems to be predicated upon a belief that financial futures are somehow related to the successful implementation of monetary and fiscal policy. I am unaware of either acceptable economic theories or empirical evidence to support this view. Once again, Professor Houthakker may be right, but I do not think he has provided us with an explicit enough analytical foundation to permit an evaluation of his conclusion.

It should not have to be said, in closing that Professor Houthakker has consciously attempted to stimulate our thinking about a number of important issues in futures markets regulation. While I have been critical of some of his conclusions, it is more often true than not that in economics a critical ingredient in our learning process is to have someone fearless enough to make a strong assertion to which others can respond. Professor Houthakker has performed this role admirably.

³ See, for example, Commissioner James Stone, "Additional Comments on the Interagency Study of Silver Markets," CFTC, June 1981, p. 45.

DISCUSSION

S. SMIDT*: One important development in economic theory in recent years has been the effort to deal with agency problems. If successful, this will enlarge the

* Cornell University, Graduate School of Business and Public Administration.

scope of economics to include the structure of social institutions and perhaps even the structure of personality. This paper is a part of that development.

The traditional literature on securities markets gives abundant recognition to the potential conflicts of interest between the principal and his agent in achieving best execution. The legal literature deals with this conflict by establishing legal and ethical norms. The agent is admonished to sacrifice his own interests to those of the principals for whom he acts. Garbade and Silber perform a useful service in reminding us that the problem of best execution has significant economic content.

Best execution is an interesting issue on which to test how much progress we have made in agency theory. The relationships between a broker and his customers are relatively simple compared to some of the relationships with which agency theory deals. Furthermore, there are a variety of market institutions and a correspondingly wide variation in principal-agent relationships to help in sorting out causal relationships. If we cannot understand the behavior of agents and principals in a security market setting, it is unlikely that we can succeed in understanding the analogous, but more complex phenomena in a corporate setting.

In the first substantive section of their paper, Garbade and Silber define best execution as a transaction that takes place when the cost of obtaining an additional quotation exceeds the expected improvement in price. This is the test that a trader would use when acting for himself in deciding whether or not to seek another quote. Agents, according to Garbade and Silber, provide best execution when they apply the same standard to their customer's orders. This definition treats best execution as an optimal search problem and recognizes the cost of searching. It contrasts with the legal definition of best execution as finding the most favorable price, regardless of cost.

In their algebraic treatment, the authors assume that the principals and agents each have known, but not identical, probability distributions for quotations. This omits an important aspect of the process. In this formulation, the only benefit of an additional quotation is that it may lead to a better price. A Bayesian formulation would be more appropriate in that it would recognize that additional searching provides a better estimate of the distribution of quotes as well as the possibility of finding a more favorable one.

In part 3 of their paper, Garbade and Silber consider why agents are used. They identify two reasons: lower search costs and knowledge about the distribution of available quotes. A principal who believes that his broker has better knowledge about the distribution of quotations may use the broker (rather than conduct the transaction himself), even though he may not be sure that the broker will provide "best execution." In brief, the agent's "second best" execution may be better than the principal's best.

There are many other factors that may influence the choice between agent and principal. For example, a quote supplier may provide a better quote to a professional agent than to a principal, if he believes that the professional has a better knowledge of the distribution of quotes and/or lower costs of obtaining quotes.

Another reason is that the principal may wish to conceal his identity. This is likely to be a factor if the identity of the principal and the knowledge that he is

seeking a quotation is itself a signal about the state of the market. In these circumstances a principal may use a broker to achieve anonymity, even though he does not expect to achieve best execution, and has lower search costs and better information about market conditions than his broker. I am told that this is not uncommon on commodity futures markets.

Still another reason for using an agent is to reduce the credit risks for the other side. On most organized exchanges, only members may trade. Credit-worthiness is a condition of membership. When members act as agent, they must guarantee the credit of their principals.

On the most important issue in this section of the paper, I agree with the authors. Agents, as a group, do not have to offer best execution to attract business. It is sufficient for them to offer "better execution" than the principals would provide for themselves. In positive economic terms, the fact that principals use agents to conduct transactions is no evidence for the proposition that agents are providing best execution in the legal, or even in the economic sense. Although the paper typically compares executions by principals and agents, the relevant alternative for the principal is usually which agent to use.

In part 4, the authors consider conflicts of interest, particularly as they are affected by compensation schemes. This reflects the tradition in agency theory that compensation schemes should be evaluated by how effectively they induce agents to behave the way a principal would have them behave. Part 5 examines some techniques principals can use to control the behavior of their agents. A problem is that these analyses attempt to encompass all securities markets. Since the specific characteristics of the agent, the principal and the competitive environment are not explicit, the validity of conclusions, which might be correct if they were properly qualified, is sometimes left in doubt.

Garbade and Silber's main conclusion "is that best execution in securities markets is accomplished through a variety of contracting, signalling and collective action arrangements." Although I disagree with few of the details of their analysis, my main conclusion would be that the advantages of agency relationships are so overwhelming in most security transactions, that the agency system is used even though there is no effective guarantee of best execution. A second conclusion is that focusing on how to get agents to behave as if they were principals (the best execution issue) is not an effective research strategy. Best execution may be a fundamental issue for lawyers, but not for principals and agents in securities markets. A better question might be how to maximize profits for a firm whose comparative advantage is executing securities transactions. Presumably the answers, whether to be an agent, a dealer, or both, and the relative weights to assign to favorable transaction prices, fast execution, personal service, guarantee of financial reliability, etc., will vary with the characteristics of the securities, the customers, the technology, and the competition.

DISCUSSION

A. KALAY*: This paper constitutes an interesting attempt to shed light on the operation of financial markets where the focus is on the institutional arrange-

* New York University, Graduate School of Business Administration.