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The Intermarket Trading System and NYSE-Listed Stock

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Summary

The Intermarket Trading System (ITS) facilitates stock trading between the New York Stock Exchange (NYSE) and other exchanges trading the same stocks. Another component of the stock trading system, Alternative Trading Systems (ATS) -- computer-driven order matching systems -- have become a large factor in the trading of Nasdaq-listed stock. But the ATS play a very limited role in the trading of NYSE-listed stocks because they are not members of the ITS. There are, however, a number of changes afoot and in March 2000, ATS gained the right to access the ITS through Nasdaq linkages. However, a number of ATS are pushing for inclusion in the ITS as members; present rules, however, forbid this. Due to SEC-advocated regulatory reform, some ATS, however, have started to access the ITS indirectly through interfaces with NASD market makers who trade NYSE-listed . But, others criticize this as a solution that is both deficient in basic fairness and technologically too slow.

Introduction

The Intermarket Trading System (ITS) is a consortium of U.S. stock exchanges that oversees links for New York Stock Exchange-listed (NYSE) stocks. The ITS' fundamental goal is ensuring that the best quotations or quotes (lowest offers to sell and highest offers to buy) in the stocks are distributed to its various member exchanges that trade the stock. The member exchanges [1] are: the NYSE, the American Stock Exchange (AMEX),[2] the Boston, the Pacific, the Cincinnati, the Philadelphia, the Chicago Stock

[1] The exchanges are self-regulatory organizations (SROs). SROs are non-government organizations that have statutory authority to regulate their own members. The NASD is the parent organization of the Nasdaq stock market which is technically not a stock exchange (with its decentralized array of independent traders), but the NASD is a SRO.

[2] The ITS also facilitates trading linkages among its members who trade AMEX-listed stocks and options.

Exchanges, the National Association of Securities Dealers (NASD), and the Chicago Board Options Exchange.

The ITS was established over 20 years ago by its members at the urging of the Securities and Exchange Commission (SEC). The Securities Acts Amendments of 1975 authorized the SEC to facilitate the establishment of a fully integrated system of U.S. securities markets known as the "national market system" (NMS). The seamless linking of venues which traded stocks listed on key national exchanges became a major objective in developing the NMS. This linkage became the ITS.

The ITS performs its mission by providing facilities and procedures for: 1) displaying its members' composite quotations (offers to buy and sell stocks at various prices or prices); 2) executing orders among members; and 3) coordinating market openings among the linked markets. The dissemination of quotations to the various members of the ITS is done through the affiliated system known as the Consolidated Quote System (CQS). (An affiliated system is the Consolidated Tape Association (CTA) collects and provides consolidated last sale trade data from the various ITS member firms' trades of NYSE-listed stock)

Although considerable information is exchanged by ITS, relatively little order execution occurs there. In September, 1999, the ITS volume represented 2.2 percent of the total volume of NYSE-listed trades

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The body of rules and regulations which govern all aspects of the ITS is known as the ITS Plan. Changes to the ITS are accomplished by changing the Plan. The Plan are accomplished by amending the Plan in one of two ways: 1) amendment by the SEC; or 2) the unanimous consent of all ITS members.[3]

ITS Linked Venues Trading NYSE-Listed Stocks

Several principal venues trade NYSE-listed stock and are linked by the ITS. They are the NYSE, the regional stock exchanges, and the collection of "third market" dealers. We briefly describe these venues below.

The NYSE Stock Exchange

There are currently about 3,000 stocks listed on the NYSE. A number of market centers trade those stocks. Of course, the principal market center for NYSE-listed stocks is the NYSE itself. In September 1999, 74 % of the trades in NYSE-listed equities were executed on the NYSE itself.[4] Retail stock orders that brokerage firms route to the NYSE

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[3] The SEC must still approve all ITS-initiated amendments to its Plan.

[4] *Self-Regulatory Organizations: Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc. To Rescind Exchange Rule 390; Commission Request for Comment on Issues Relating to Market Fragmentation*. SEC Concept Release, February 23, 2000. p. 7.

are executed by exchange-based operatives known as specialists.[5] There is generally one specialist per stock, although in a few cases, specialists may trade in two stocks. Specialists basically act as agents who match incoming orders in shares of the stock that is entrusted to them. Occasionally, there may be temporary shortages of buyers or sellers, and a specialist may buy or sell for its own account using its own capital and/or stock inventory to right that imbalance. Specialists are monitored and regulated by the NYSE which is also a member of the ITS.

The Regional Stock Exchanges

There are five regional stock exchanges, the Cincinnati, the Pacific, the Philadelphia, the Boston, and the Chicago which are also market centers in NYSE-listed stock. Decades ago, trading in local or regional stocks constituted a substantial part of the regionals' trading volume. But this has not been the case for many years. The regionals are now principally satellite markets for the trading of AMEX and NYSE-listed stocks. The regionals generally employ specialists who act primarily as dealers[6] who make markets in various stock through trading for their own account. The Boston and the Cincinnati exchanges allow competing specialists to make markets in the same stocks (similar to Nasdaq's multiple dealer system). As a group, the regionals currently account for about 8% of the trading volume in NYSE-listed stocks.[7] Each regional is a member of the ITS.

The Third Market

The "third market " is the collection of independent Nasdaq broker-dealers who in addition to trading Nasdaq-listed stocks also trade stocks listed on the NYSE. Third market broker-dealers tend to compete for order flow against the NYSE not competing through spreads, but through internalization (filling orders from their own account) and matching prevailing NYSE stock prices. The third market currently accounts for about 8 percent of the volume in NYSE-listed stocks.[8] The NASD which regulates all broker-dealers and which is the parent organization of the Nasdaq stock exchange, is the third market's representative on the ITS.

While the regionals and the NYSE are linked directly to the ITS, Nasdaq operates an indirect linkage to the ITS for third market dealers. The interface is known as the Computer Assisted Execution System (CAES) and it allows third market dealers to enter limit and market orders in NYSE-listed securities to be executed against other market

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[5] There are also block trades of 10,000 shares or more which often involve institutional investors trading between themselves. This is known as the "upstairs market" or alternatively the "fourth market."

[6] In a dealer market, the traders in specific stocks risk their own capital to trade with incoming order flows of the stocks, hoping to make a profit as they buy the stock at relatively low prices and sell the stock at higher prices, the difference being their gross profit which is known as the spread.

[7] *Market Structure Report of the New York Stock Exchang*e. New York, 2000. p. 26.

[8] Doran, Lynn. Market Making in the Third Market for NYSE-Listed Stocks. *The Financial Review*, November 1, 1999. p. 1.

makers' quotations in those securities. CAES also provides third market dealers with a link to the ITS. In turn, the ITS allows third market dealers to take part in the Consolidated Quotation System for NYSE-listed stocks between the various ITS members who trade the stocks.

Alternative Trading Systems

Alternative trading systems (ATS)[9] are the nine computer-driven, totally automated systems that primarily trade "limit orders"[10] submitted by retail investors (via brokerage firms) and institutional investors. ATS, which offer fast and cheap order execution, have grown from one or two to the current nine in just a few years. They are regulated as broker-dealers, although a couple are applying to the SEC for the far more stringently regulated SRO status.[11].

ATS currently account for about 25% of the trading volume of stock listed on the Nasdaq stock market. But, in part because of their lack of access to the ITS, they account for only about 4% of the trading volume for stocks listed on the NYSE. This small amount of trading that they do is largely done through ATS that have connected to NYSE member firms or that trade NYSE-listed stocks in isolated environments through their individualized network links.

As ATS have become more important in recent years and the benefits of their added competition have widely translated into lower investor costs and a wider choice of trading venues, the SEC has pushed to have them gain access to the ITS. SEC officials have emphasized that integrating ATS into the ITS would help to further the central National Market System goal of price transparency (making all stock quotes and transaction prices readily accessible). SEC officials also have stressed that integrating ATS into the ITS would give dealers in the third market as well as other markets access to ATS' quotes in NYSE-listed stocks providing increased competition and its attendant benefits.

Recent Developments

In 1999, the SEC began considering a policy option to amend the ITS Plan to provide the ATS access to the ITS through the ITS/CAES link that is available to the dealers in the third market. And, in March of 2000, despite NYSE opposition, the SEC approved the proposal (formally an NASD proposal) and amended the ITS Plan to give ATS access to the ITS through the CAES link. A key NYSE concern was that if ATS, who are not

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[9] ATS are also called electronic communication networks.

[10] Limit orders are offers to buy a certain number of shares at a certain price or less or to sell a certain number of shares at a certain price or more.

[11] SROs are subject to more comprehensive regulation as well as numerous self regulatory requirements. But, earning SRO status also confers a number of benefits, including the ability to earn revenue from the sale of the market data that you produce as well as membership in the ITS

members of the NASD or the NYSE, are linked to the ITS, they would be unfairly "free riding"on the liquidity of the various ITS members.[12]

In March 2000, about the same time that the SEC was approving the new ATS link to the ITS, the NYSE announced that after much study, it had decided that it was in its best interests to lobby the SEC to scrap the ITS. NYSE officials argued that the ITS was increasingly antiquated (a point that is agreed with by the SEC and virtually all market participants.) In addition, NYSE officials asserted that advances in communications technology have introduced more direct and efficient means of routing orders among markets than intermarket linkages like ITS. NYSE officials noted that new technology could enable broker-dealers to fulfill their duties of best-execution[13] through their own information and order-routing systems rather than through traditional exchange linkages like the ITS. Shortly after indicating its interest in scrapping the ITS, the NYSE also indicated that it wanted to scrap the CTA, which consolidates and disseminates last sale data received from the various market centers NYSE-listed stock trades. The NYSE has spoken of unbundling the sale of its market data from the other members of the CTA and selling it on the free market with the hope that it could yield far greater returns from the sale of the data than it currently does.[14]

To date, the SEC's response has been that despite its shortcomings, the ITS still plays a necessary role. The SEC would have to approve any changes to the ITS, including its dismemberment.

In June 2000, on the heels of the SEC's approval of ATS' access to the CAES, the Nasdaq announced that three ATS -- BRUT -- Bloomberg Tradebook and MarketXT -- would become full-fledged Nasdaq third market dealers who would be entitled to access the ITS through the CAES. However, other ATS are not sure whether they will join the third market, which was recently named the Nasdaq Intermarket. Several ATS (as well as some traditional third market dealers) describe the ITS as both unreliable and unstable. Some note that while ATS can execute orders almost instantaneously, the ITS has a one minute minimum life for its stock orders.

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[12] A major boost to the ability of both ATS and third market dealers to trade in all NYSE-listed stock took place in March 2000 when the NYSE (after considerable SEC lobbying) rescinded its Rule 390 that had effectively prevented stocks listed on the exchange prior to April 26, 1979, from being traded outside of the NYSE and regional exchanges. Rule 390 had applied to about 23 percent of the exchange's total listings and about 46 percent of the NYSE's volume.

[13] Best execution is the fiduciary obligation of a broker-dealer to obtain the most favorable terms reasonably for a customer's orders under the given circumstances.

[14] Currently, representatives from the NYSE, various ATS, and other segments of the securities industry are taking part in a SEC-directed panel told to deliberate and then to advise the agency on various stock market data issues. Chief among the issues, is the NYSE's proposal to break from the CTA. The panel held its first meeting in October 2000.Currently, representatives from the NYSE, various ATS, and other segments of the securities industry are taking part in a SEC-directed panel told to deliberate and then to advise the agency on various stock market data issues. Among the issue is the NYSE's proposal to break from the CTA. The panel held its first meeting in October 2000 and it held its second meeting then in December. Presently, the panel appears to be basically divided between one camp that believes that the CTA should be "fixed," and another (which includes the NYSE) which believes that it should be scrapped entirely.

The ATS community appears to be of several minds on the issue of joining up with Nasdaq dealers for indirect ITS access. Some, like Instinet, view the indirect link as an interim step. Others, however, are reportedly considering rejecting the CAES interface because their first priority is in this area is a major overhaul of the ITS itself. Key components of the desired overhaul include: 1) opening ITS membership up to the ATS directly; 2) providing for a more flexible ITS governance structure by scrapping the requirement that any change to the ITS Plan requires the unanimous consent of all members;[15] and 3) overhauling the mechanics of the ITS' intermarket linkages so that it works faster and more reliably. Some of the ATS who plan to use the CAES/ITS interface have historically embraced a number of these proposals as well.

In early September 2000, the alternative trading system Archipelago became the first of the ATS to begin trading NYSE-listed stocks via the CAES/ITS interface

The NYSE has strongly criticized these sweeping proposals for the reform of ITS. Exchange officials say that to ensure free and fair competition, the SROs in the ITS need to be able to maintain complete control over their own "business model." They also contend that the inclusion of non-SROs (such as ATS) in ITS' governance structure would hold the ITS consortium "hostage" to the parochial and potentially incompatible interests of those dissimilar entities.

In January 2001, preparing to leave the SEC after 8 years as its chairman, Arthur Levitt did some reflecting on the future of the ITS and the ATS. These included the views that: 1) A key problem of fully integrating ATS into the ITS is reconciling the fact the ITS provides investors with the highly important best quotes in a stock, while ATS are not always able to provide the best quotes – but they are much more consistently able to provided faster trade executions; and 2) The public interest may ultimately not be served by an attempt to integrate ATS into the ITS, but may instead be best served by allowing ATS to display their listed quotes without being forced into the ITS per se.

As part of this commentary, Chairman Levitt posed a number of broad public policy questions about the future of the ITS:

> On what terms must ECNs [ATS] and exchanges provide access to one another? What mechanisms will be used? Any answers, of course, must accommodate the possibility that not just alternative markets, but the NYSE will operate outside ITS.[16]

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[15] In 1998, the SEC proposed that the ITS unanimous consent requirement be abandoned. (See: SEC Proposes to Expand NASD Access to Intermarket Trading System. *Daily Report for Executives,* August 7, 1998.)

[16] Chairman Levitt: Market Has Room for More Efficiency. *Securities Industry News,* January 15, 2001.