Exchanges and Markets

As the campaign for ETF trading volume presses on, Island goes dark, Arca grabs market share and the major exchanges fight to hold their own.

By Zachery Kouwe

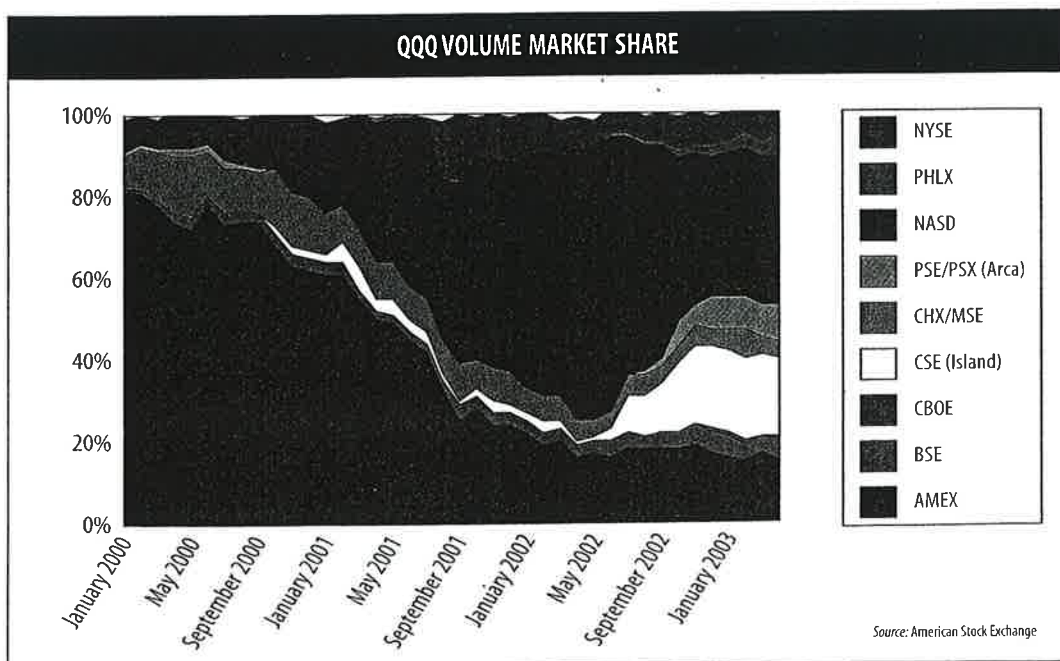
Institutional Investor's ETF Report

On April 15, seconds after Microsoft Corp. reported better-than-expected earnings, Jim Chen, managing director of Bear Stearns' index arbitrage unit, got a call from an institutional client. Betting the Microsoft news would move the entire tech market, the client wanted to buy 40,000 shares of the Nasdaq-100 Index Tracking Stock, or QQQ. And he wanted to get filled "on the wire," meaning he wanted the purchase completed before hanging up the phone. Although the trading day was over and most of the markets were closed, Chen was able to fill his client's order in a matter of seconds by selling shares from Bear's own inventory.

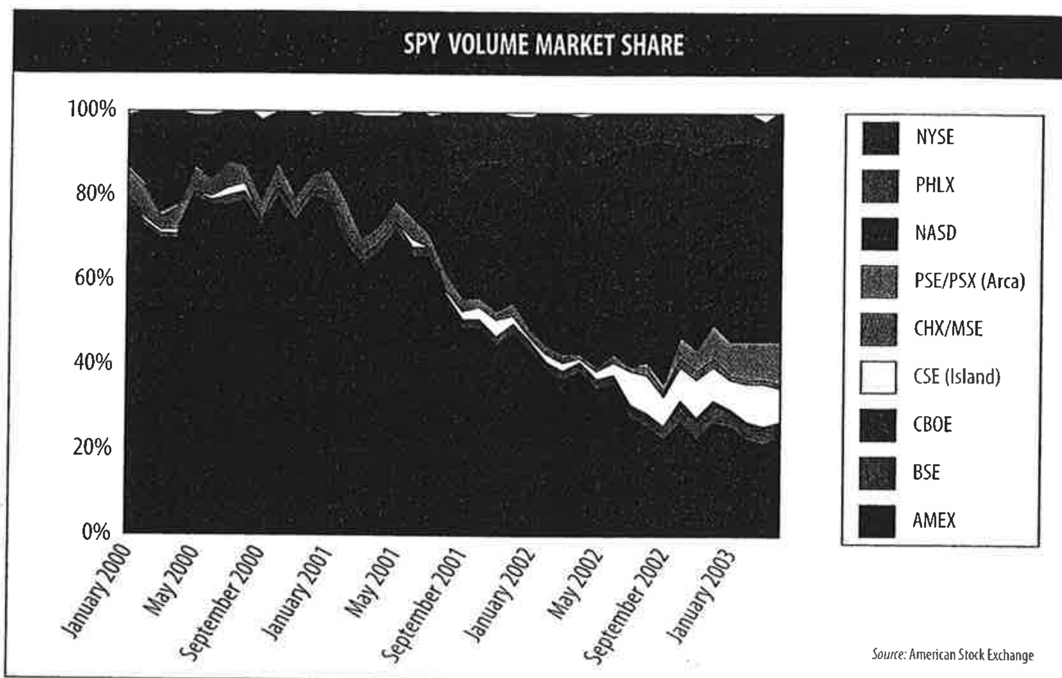
"That's the reason they come to us," Chen says. "They're looking for liquidity, and right now they got nowhere to go because the market is closed. But, even during the day, people looking to put a lot of money to work will come to us." Upstairs market trading activity is hard to quantify, but industry executives say that over the past year more and more institutional investors have gone "upstairs" for ETF trades because the venue provides anonymity, speed and the ability to get a large order executed at one time.

Meanwhile, the number of competitors providing this service has increased. "All of the big houses are now doing it," says Tom Jardine of Dresdner Kleinwort Wasserstein. "The barriers to entry are small. Once you pick up the business model, if you have a portfolio trading infrastructure, you can get into the business."

The upstairs market is growing, but the vast majority of all ETF trading still takes place on the traditional floor-based or electronic marketplaces. The Amex and the Nasdaq Intermarket account for more than half of all trading in the QQQ, the most actively traded ETF, and more than 70 percent in the S&P 500 Depositary Receipt, or SPY, according to Amex data. That's down from a year ago, when the two markets accounted for more than 80 percent of all volume in both ETFs, but still an impressive concen-



Source: American Stock Exchange



tration. Making headway is the newly formed Archipelago Exchange (Arca) — a merger between the Archipelago ECN and the Pacific Stock Exchange — and Island, whose trades often show up on the Cincinnati exchange.

Where traders find the best prices and the best executions are important questions asked on a daily, if not on a minute-by-minute, basis. The answers change as frequently as the question is asked. The choice of venues is broad: ETFs are traded not only on the major exchanges and markets but on several ECNs, such as Island and BRUT, as well as Archipelago, the third market and the derivatives markets, which offer options and futures contracts on ETFs.

Available liquidity is a major factor in where traders choose to send their orders, and every exchange or electronic marketplace that trades ETFs feverishly competes for this liquidity and a slice of the overall ETF order pie. Orders for the QQQ, DIA and SPY are the most coveted because they are so heavily traded. Indeed with an average of 73 million shares traded per day, the QQQ is the most actively traded listed security in the U.S.

Island goes "dark"

The most significant change in the ETF marketplace, according to traders and ETF insiders, occurred last fall when the Island ECN, the dominant liquidity provider for the QQQ, decided not to display its quotes in five of the most heavily traded ETFs: the QQQ, DIA, SPY, SMH and MKH.

Island decided to go "dark" because the Securities and Exchange Commission, responding to frequent complaints by the Amex and other exchanges, forced Island to post its best bids and offers for certain ETFs on the National Consolidated Quote System. The NCQS is a facility that collects the quotes from every market center that participates in the Intermarket Trading System (ITS).

The background is complex. Ever since Island — now owned by Instinet Group — began to trade ETFs, the ECN has consistently complained that the ITS was an inferior system that would prevent its clients from getting the extremely fast executions they had become accustomed to. Their argument rests on an ITS rule known as the trade-through rule, which requires an ITS participant to execute a trade at the best possible price, even if that means sending the order to another market center.

Island argued that adhering to the trade-through rule would greatly curb the execution speed of its ETF orders because, according to the rules, the competing market center would have up to 30 seconds to respond to Island's quote.

The SEC took up Island's concern by issuing what is known as the de minimis trade-through exemption rule. This temporary rule, which took effect on September 4, 2002, allowed Island and other ITS participants to trade through another market's ETF

quote if their own quote was within 3 cents of the best bid or offer. The rule, which applied only to the QQQ, DIA, and SPY, was supposed to pave the way for Island to become a participant in ITS and begin posting its best bids and offers on the NCQS.

But the de minimis trade-through exemption rule didn't end up applying to Island, because the SEC also decided to require any ECN that held more than 5 percent of the trading volume in an ETF for four of the last six months to post its quotes on the NCQS. And Island's market share was above the 5 percent threshold in several ETFs. The only way to duck out of this requirement, the SEC said, was for an ECN to pull the plug on the public display of its quotes. Island was forced to make a strategic decision. Rather than post all of its bids and offers on the NCQS, Island decided not to show its quotes to anyone.

Island still maintains that going dark was a decision it was forced into making. "We never suggested that it was the best alternative for our customers when we had to adopt that approach [going dark.] Just given the restrictions imposed on us if we participated in ITS, this was the only way could continue to service our customers," says Island spokesman Andrew Goldman.

After Island shut the lights off on the QQQ, DIA, and SPY, its market share in these instruments began falling. According to the Amex, Island's share in the QQQ fell about 13 percent in the first two weeks after the ECN went dark. And Island's piece of the DIA fell by over half, Amex data indicates. Island declined to provide current ETF trading volume figures.

"Island going dark led to some participants dropping out of Island and, to a certain extent, participants dropped out of playing in the ETF market at all," says Brett Redfearn, senior v.p. of business strategy and equity order flow at the Amex.

The biggest beneficiary of Island's move was Archipelago (Arca), because as an all-electronic exchange it served the same function as Island: it could execute trades at very high speeds. "Our market share in ETFs is in the 13 percent range, which is up significantly from 4-5 percent last September," says Archipelago senior strategist Jenny Drake. Also up significantly is Arca's internal liquidity – achieved by matching buyers and sellers within its own system instead of grabbing liquidity from another marketplace. Because Arca is crossing a much higher percentage of customer orders than it was a year ago, Drake says, it is a more attractive venue in that it is functioning more like one of the big exchanges.

Tape Sharing

A number of ECNs, including Arca and Island, can claim a competitive advantage in the ETF market in that they give clients a portion of the market data revenue they receive from printing trades on the NCQS. By sharing these revenues, the ECNs are incentivizing traders to use their trading platforms. The Amex and the NYSE have chosen not to get into this business, which they call controversial.

"On a relative basis, the economics of using the floor have increased over the last year as competitors have aggressively reduced pricing in ETFs," Drake says. "For example, on Arca, liquidity providers receive liquidity and tape rebates." ETF trades bring in almost $2.00 in tape revenue for every print, she says.

The Amex's Redfearn and other exchange executives criticize tape-sharing agreements because they can sometimes entice firms to print what are known as "wash trades." Wash trades are simultaneous trades made on both sides of the market executed at the same price. In this illegal scheme, no beneficial ownership of shares changes hands, and the trading firm profits from the market data rebates.

"The game that started to evolve out of this tape sharing practice with these end customers was in fact incenting firms to develop their business plans largely around the ability to get tape revenue," Redfearn says.

Case in point: In October 2002, Swift Trade Securities, Inc. and its president, Peter Beck, settled with the NASD after the regulatory body began investing the Toronto-based brokerage firm for allegedly developing and running a computer software program that routed simultaneous offsetting limit orders for the QQQ to Island. The firm and its president were jointly fined $75,000 and were required to disgorge the $26,000 in profits made from fictitious wash sales. Beck was also suspended from the securities business for 30 business days.

"Now, all of sudden, we realized that some of the trading activity that had been driving Island was fake. It was fraudulent," Redfearn says. He notes that, to a certain extent, the practice of wash trades is still going on because the business of tape sharing is still fundamentally flawed.

The AMEX fights to remain competitive

The first exchange to list and trade ETFs, the Amex continues to garner between 25 and 30 percent of all ETF trading volume. It also received a small uptick in business when Island went dark, according to Redfearn. But the exchange is fighting against an increasingly competitive landscape, and over the past couple of years has given up market share in both the QQQ and SPY.

To remain competitive, the Amex is focusing on several strategies, including the reduction — and elimination — of customer fees. "As other markets have UTP-ed our securities, we have essentially eliminated customer fees so that, in addition to providing liquidity and better executions, we remain cost competitive as well," Redfearn says. UTP, or unlisted trading privileges, is the practice of trading a product listed on another exchange. The Amex also continues to make technology enhancements to ensure execution speeds in ETFs are as fast as possible and recently teamed up with the Big Board to share technology that enables member firms to place orders faster.

The exchange has also been encouraging floor traders to use its automatic execution system more aggressively. As part of this effort, Redfearn says, the Amex has proposed to eliminate what is known as the "speed-bump" rule. This rule allows only one electronic order every 30 seconds to be eligible for auto-execution; its removal would allow firms to place auto-ex orders more frequently. The SEC is currently considering the proposal.

Meanwhile, the Big Board, which entered the ETF market only two years ago, still lags behind. The exchange did begin to trade more Amex-listed ETFs last year, and is working on developing more of its own index products. But its market share in the QQQ, DIA, and SPY has remained flat – around 7 to 8 percent of overall ETF volume. "They are really not getting the volume they deserve," says Bear Stearns' Chen, who sends some trades to the NYSE. "But it takes a long time for people to change their routing practices."

With that said, it's clear the battle for ETF trading business is far from being won. Island says it is working with the SEC to find a way to turn the lights back on for its QQQ, DIA and SPY quotes, which could pull more trading business back in. And the Amex's myriad efforts to remain competitive could gain momentum, as could Arca's strategy to build its ETF business.

Regardless of which venue ultimately dominates, one thing is clear: the ETF marketplace has become better for traders and investors. Liquidity has improved and the competition for customer order flow has given investors faster executions and better price improvement. Says Chen: "Over the last year spreads have really narrowed, and the ETF marketplace has matured to a point where trading is pretty much occurring at fair value."

Zachery Kouwe is currently a freelance journalist and former reporter for Wall Street Letter.