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Why Wall Street Needs Another Stock Exchange – ISE Midpoint Match

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Disclaimer: The author of this paper, Christine Malia, is an employee of the International Securities Exchange, the company that will be explored in this paper.

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I. Introduction

The New York Stock Exchange moving to some warehouse in New Jersey? It is not impossible with the way that electronic trading platforms have really changed the market environment. There is no longer the need for a central physical location where all business is conducted, as once specified by the Buttonwood Agreement in 1792. Electronic trading has even paved the way for a new power player in the industry—the International Securities Exchange. Originally founded as a fully electronic options exchange, they have recently launched an electronic stock exchange, known as Midpoint Match.

So what impact does this have on the rest of the market? On the rest of the business world? The idea of the floor broker is fast diminishing—a majority of trades in today's markets are executed electronically in milliseconds without the necessity of a trading floor. Efficient electronic markets, like the ISE are just another example of man being replaced by the machine. Could this significant change mean less of a need for people who know just the business side of trading and more of a need for people who know the technological aspects to trading? Could it mean more computer science and IT majors working on Wall Street than finance, economics, and math majors?

The average investor needs to be aware of the rapid changes currently taking place in the marketplace environment—recent market consolidation, specifically. Recent market consolidation is important for an investor to know about because it means not only increased market efficiency, but major cost reduction. The NYSE merger with Archipelago last year made it not only a floor-based exchange, but also an electronic exchange. The CBOT merger with the CME in October of 2006 brought commodities and futures together so that they could be traded all in one place. In order to stay competitive, every exchange will have to lower their costs—in light of the new technology based trading environment.

So will the International Securities Exchange, which has been tremendously successful as the leading fully electronic options exchange, be able to reach the same level of success with the launch of its new equity platform, known as Midpoint Match? This is the question that this paper intends to answer. Section II will discuss the background of the ISE; Section III will discuss what is so special about Midpoint Match, the new ISE stock exchange; Section IV will discuss industry opinion in terms of possible cons for Midpoint Match; Section V is a commentary on the recent market mergers and acquisitions and what it means for Midpoint Match; and Section VI will conclude. The method that I used to answer this question was through personal interviews with business professionals.

II. Background of the ISE

The International Securities Exchange was launched on May 26, 2000 by David Krell and Gary Katz, former executives of the NYSE options division. It was the first registered exchange approved by the Securities and Exchange Commission since 1973.

The possibility of forming a new U.S. options exchange was first manifested in 1997, when William A. Porter, then-Chairman of E*TRADE, and his colleague, Martin Averbuch, engaged Krell and Katz to examine the idea. In order to support the creation of a new exchange, Porter and Averbuch formed Adirondack Trading Partners, LLC, or ATP, a consortium of broker-dealers and other investors whose purpose was to arrange financing for the development of the ISE and also to create order flow for the exchange. Only the most liquid options classes, which represented 90% of industry volumes, were listed on the ISE¹.

The ISE was the first fully electronic options exchange. The advantages of the new ISE options exchange were several fold. First, it provided increased efficiency with 0.2 second executions, much faster than the other exchanges offered at the time, and electronic linkage of all markets to ensure that their customers received the best price possible. Before the markets were linked, people just assumed they were getting the best possible price.

Another advantage of the ISE is its customer service desk. The ISE Market Operations department consists of fifteen people, all available to answer customer calls and handle any issues. The phone system evenly distributes calls among these fifteen people so that each person carries his/her load. The customer service that the other options exchanges offer does not measure up, meaning that they might have one or two people working the phones, and those one or two people cannot possibly handle all of the customer call volume in a trading day. According to James Sampson, Head of Market Operations at the ISE, “Approximately 92% of our members are either ‘very’ or

¹ International Securities Exchange, Inc. Investor Relations FAQs. Iseoptions.com. 24 September 2006. <<http://phx.corporate-ir.net/phoenix.zhtml?c=176358&p=irol-faq>>.

‘somewhat’ satisfied with our customer service².” This whopping statistic alone is clear evidence of the ISE’s popularity in terms of options customer service.

A basic example of why customer service is so important is the following—suppose a market maker meant to buy instead of sell, or vice versa. If this market maker traded on another exchange and tried to call their help line, he would probably have to listen to an automated system, punch numbers into his keypad, and let the customer service line ring about twenty times before he gives up since there is clearly no one there to answer him. If he traded on the ISE, by contrast, he would simply call their help line, which is direct—no automated system—and his call would be immediately answered and handled by one of the market operations representatives. The ISE has received several awards for its superior customer service, and it continues to have the best customer service desk. Even though markets are electronic to hasten orders, there is still the need for human interaction when it comes to correcting or busting (canceling) trades.

On March 9, 2005 the ISE became the first securities exchange to sell shares in an IPO on the NYSE (symbol: ISE). Over ten million shares of ISE’s common stock were offered in the IPO at \$18.00 a share. At closing that day, the share price went up to \$29.00 per share. The ISE received net proceeds before expenses of approximately \$67 million from its IPO. On the second day of trading, when ISE was bought and sold in the secondary market, the closing price that day was \$29.95 per share. ISE reached a high of \$55.08 in November 2006, and currently trades in the \$50-\$54 range. In only a matter of six years, the ISE was able to surpass all of its competitors in the options industry—the CBOE, the BOX, the PHLX, and the PCX—in terms of industry volume with their promise of fast and efficient transactions as well as unmatched customer service.

²C. Malia. Personal Communication. December 8, 2006.

The average investor probably doesn't know that the ISE itself is not nearly as large as the NYSE or the CBOE, one of its more direct competitors. It occupies only five floors of its headquarters building, and it is only comprised of about 200 employees. Yet on a day-to-day basis, the ISE Options Exchange beats out the CBOE, NYSE, PCX, PHLX, and BOX with the most daily trading volume (equivalent to 30+% of the total market). The fact that a midsize company has that power and capability shows that it is a force to be reckoned with, and its equity exchange will probably mirror the same success in time to come.

Based on the past successes of the ISE with options, they are likely to do the same on the equities side. Philip Gocke, Managing Director of the Options Industry Council, in a personal interview, expresses "a lot of respect for the management of the ISE" and "if they did not think that this exchange was a good idea, they wouldn't have pushed the idea through" (Gocke). Mr. Gocke remains confident that the ISE will succeed and says that it is very likely "provided that they develop reasonable market share within the 2-5% range" (Gocke).

The ISE Options Market came into the right place at the right time; and so did Midpoint Match. Andrew Brenner, Managing Director of Midpoint Match, in a personal interview that I conducted, astutely points out:

With the new SEC regulation known as Reg NMS (National Market System), there is a level playing field. There is price protection, meaning that if the ISE were to have the best price, other exchanges are no longer allowed to trade through us, which was done so many times in the past. All the electronic exchanges have been linked together, which is important because now trades will be routed to the exchange with the best price. (Brenner)

So ISE Midpoint Match has a fighting chance against popular and longstanding exchanges, such as the NYSE and the NASDAQ because Reg NMS levels the playing field.

III. So what is so special about the ISE launching yet another stock exchange?

So what does Midpoint Match bring to the table? The fact that it is fully electronic means that it is fast. Mr. Brenner had this to say about how ISE's current Midpoint Match platform measures up to the competition: "Our system currently executes trades in under 3 milliseconds, and it's going to get faster as we improve. The NYSE brags about executing trades in under 300 milliseconds, just to give you an idea" (Brenner). So why is this small amount of time so important? Well, time is money, and in the exchange environment, prices can change in an instant. With less than 3 millisecond executions, Midpoint Match promises their customers to get them the price that they want before the price has time to change. If an exchange wants to be the best, it has to promise its customers that they can get them their price.

What else does Midpoint Match have to offer? It offers continuous price improvement, which means that it adjusts every order that comes through the system to be the midpoint between the National Best Bid and Offer (NBBO) price, which is the spread between the best buy price and the best sell price. Midpoint Match will make sure that every order is at the midpoint of these two prices, which makes it even better than the best buy and sell prices in the market. Matching orders at the midpoint of the best buy and best sell prices in the market is fair because it means that neither side of the trade will get cheated. At other exchanges, trades are conducted at the NBBO, which might not necessarily be the real "best" price in the market.

Midpoint Match also supports algorithmic trading, meaning that traders with large orders (i.e. several thousand shares which are not just bought or sold in one shot since that could significantly affect the share price) can break them up into several smaller orders and can specify how and when they will be traded over the course of a trading day. While other exchanges also offer this feature of algorithmic trading, all orders are traded again at the NBBO, and not the midpoint of the two, which is what Midpoint Match does in contrast.

Finally, Midpoint Match accepts orders of any size of at least 100 shares or more, just like other exchanges, making it attractive to the small-time investor (i.e. a Joe Schmo), as well as the institutional investor (i.e. Goldman Sachs or Merrill Lynch). This offering to the small-time investor is so critical because ISE used to be strictly an options exchange. The small-time investor might not really know much about options and frankly might not want to spend the time learning about them. With ISE Midpoint Match, the ISE can expand its investor base to the small-time investors that might not know much about options.

Midpoint Match offers a fully displayed market in addition to a non-displayed one, while the other exchanges only offer a non-displayed market. A choice of a displayed or a nondisplayed market means that brokers can decide whether or not they want to show themselves to other brokers trading on Midpoint Match. If they show themselves and their orders to other brokers on midpoint match, it means that they want their order filled right away. A broker would opt for the nondisplayed market if they have a very large order that they do not want filled all at once because, as mentioned earlier, it could negatively affect the share price of the stock they are trading. To

comment further on the displayed market, Mr. Brenner, in a wallstreetletter.com interview with Managing Editor ³Veronica Belitski, promised:

When we have the fully displayed market up and running, you'll be able to sit on the bid and hide at the midpoint simultaneously. So you get the best of both worlds: you can be reflected on the bid or the offer and if there's a midpoint match in the marketplace, you'll be able to cross without leaving a footprint and moving the stock.
(Belitski 2006)

So with the choice of a displayed or a nondisplayed market, customers can float their orders at the midpoint or check the midpoint before taking an order. Currently, no other stock exchange offers this feature.

However, the feature that the ISE is most proud of is its outstanding customer service. Mr. Brenner brags, "We have a support desk and excellent connectivity" (Brenner). The same market operations desk that handles the options transactions also handles the equity transactions. While there have not been any surveys yet conducted on Midpoint Match customer service satisfaction, it is safe to assume that the 92% satisfaction rate with options customer service gives a hint at what their satisfaction rate with equity customer service will be.

Midpoint Match also prides itself on the concept of one-stop shopping. Customers can execute their options and equity transactions on one exchange now with Midpoint Match. Mr. Brenner states, "If you are a member of one exchange [options or equity], you are a member of both" (Brenner). The ease of one-stop shopping with the ISE will naturally bring its options customers to Midpoint Match as well as attract new customers.

³ Please see *Belitsky 2006* in References section.

IV. Midpoint Match-Industry Opinion-Possible Cons

IV.a. A Very New Exchange – it needs to build liquidity

With so many appealing features, it is difficult to see the hardships that Midpoint Match has to overcome, but they do exist. Midpoint Match was only recently launched—on September 8, 2006. Midpoint will need to develop enough liquidity to capture market share. Mr. Gocke, at the Options Industry Council, points out the fact that the ISE “must develop market share to be credible” as well as have “worthwhile liquidity” to attract customers (Gocke). Often, there might not be orders on the other side to facilitate trading at the midpoint. Gocke comments that Midpoint Match will not make a significant impact in the beginning; they will certainly attract their options customers; as for new users, it may attract some and Midpoint Match may have some new enhancements—it remains to be seen (Gocke). Finally, Mr. Gocke remarks that Midpoint Match will need to make a “broader footprint in the financial market” (Gocke).

Robert Power at NYSE Listings, in a personal interview, concurs that the ISE will need a “Hub of liquidity” in order to be successful, and “it will be tricky” (Power). “Once Reg NMS goes through,” he says, every exchange “must be lean and mean to capture order flow” (Power) because of the fact that it clearly states that orders must be routed to the exchange with the best price. The only way to ensure the best price is to provide the liquidity necessary to facilitate trading volume.

In a personal interview with Tom Caprariello, Head of Project Management at the ISE as well as the Project Manager for Midpoint Match, he further agrees with Mr. Gocke and Mr. Power about building up liquidity to be successful. He states, “With the

Displayed Market launching in December, it will allow quoting, which will bring in liquidity for us. Right now, we are just doing matches at the midpoint (Caprariello).”

The displayed market successfully launched on Friday, December 8, 2006. Over 7,000 symbols that are also listed on the NYSE, the American Stock Exchange, and Nasdaq were added to Midpoint Match that day, and the exchange experienced record trading volume of over 200,000 shares at closing. On the previous day, before these 7,000+ symbols were added to the exchange, Midpoint Match had experienced record volume of 100,000 shares. The 100% increase in trading volume in a single day due to the addition of the displayed market makes Mr. Caprariello in fact correct on the subject of added liquidity with the displayed market—the feature that no other exchange currently offers.

In my interview with Mr. Brenner, he further expounded on the importance of liquidity: “How to source liquidity is the single most important thing [that any exchange needs]” (Brenner). He indicated that both a both a displayed and a nondisplayed market are a “unique” feature to the industry that only the ISE provides, and thus this feature will bring the liquidity to Midpoint.

IV.b. Fierce Competition for the ISE

Because of Reg NMS leveling the playing field for all of the exchanges, there will indeed be fierce competition in the marketplace that Midpoint will have to handle. Mr. Gocke points out that the CBOE, the PHLX, and the BOX will eventually use some form of price improvement as well—they may not have it yet, but will easily develop it. Who will succeed? It’s too early to say, but brokerage firms have taken positions in these exchanges to help. He also told me that the NASDAQ is working on its own options

exchange, making it the seventh options exchange. With yet another market to compete with, each one will have to work hard to gain market share.

The NYSE is also building itself up with its trading floor, the Archipelago electronic market, and now developing the Hybrid Market (“fast market”). Mr. Power comments that the NYSE “hopes to capture as much market share as possible” (Power). He also told me more about the Euronext merger, stating that the NYSE is “really betting to go global” and “hopes the Euronext (largest derivatives exchange) merger comes through” (Power).

An interesting fact Mr. Power brings up is that Archipelago brings volume of 800 million shares per day to the NYSE because it is fully electronic with fast technology. There is also a fully electronic platform for options on the PHLX, and now the CBOE started their own equity platform. There is a lot of volume on the CBOE equity exchange, which keeps things interesting, according to Mr. Power. Some of the NYSE brokerage firms have invested in it, which means that it has strong support within the marketplace. As for the other exchanges, such as the BOX and the PCX, Mr. Power remarks that there are brokers taking positions in these exchanges and are helping to make them more competitive as well. Mr. Power observes, “In the past five years, and in time to come, it’s become a whole new ball game” (Power).

To respond to the idea that Midpoint Match cannot measure up to its predecessors, Mr. Brenner replies:

⁴It’s pretty clear nobody needs another marketplace to trade 1,000 shares of IBM or GE. Unless we were going to provide some added value, it made no sense for the ISE to roll out another stock exchange. We feel strongly that the crossing venues (stock exchanges) are big and are going to continue

⁴ Please see *Belitsky 2006* in References section.

to get bigger, but there are also some gaps. We believe that Midpoint Match will address those needs...we've talked to the membership and we've done a fair amount of analysis, and we'll be filling a need that currently isn't being met in the marketplace. First of all, we decided to have a continuous cross (continuous order matching because the exchange is automated). Number two, it's fully anonymous. It's an exchange-sponsored crossing venue so members are assured about the safety of order information. Third, it's algo-friendly. We're willing to take any order 100 shares and above. (Belitski)

So it is clear, according to Mr. Brenner, how Midpoint will change the marketplace environment with its uniqueness, and it will undoubtedly be a success despite severe competition.

IV.c. Weak Marketing techniques?

Another disadvantage to the ISE might lie in their marketing prowess. Dr. Alan Tucker, a finance professor at Pace University, in a personal interview, comments that the people at the NYSE that "wine and dine their customers have been doing this for 25 years." The ISE cannot measure up to that because customers will be loyal to a name they know (Tucker).

Mr. Brenner fiercely disagrees with Dr. Tucker. His rebuttal was this: "The wining and dining has gone down dramatically on Wall Street in recent years. Now, it's all about whether or not you can make money for customers and if you can provide a unique product, which the ISE has done with Midpoint Match" (Brenner). So again, with doubts on the outside, the ISE will still prevail because of its innovative product offering in Midpoint Match.

To attract options customers, the ISE marketing team had a huge job ahead of them. The ISE was an unknown and a newcomer at the time, and while the ISE had

undoubtedly an amazing product in the options exchange, they still needed to attract customers to it. ISE Business Development was and still is in charge of promoting the options exchange by going to institutions and large options investors, providing them with reading material on the exchange and its features, giving them official ISE merchandise, and inviting them to ISE events, such as the annual ISE Golf Outing. It is small efforts such as these that will attract the conscious and big-time investors, and it is these same Business Development efforts that will continue to be used for Midpoint Match.

How did the Marketing Team attract other investors? According to Lauren Bauer, Assistant Brand Manager at the ISE:

The ad campaign for the options exchange consisted of six ads, and was designed to capture the revolutionary spirit of the ISE as a superior trading marketplace. The campaign initiated a ‘call to arms’ for traders to trade at the ISE. Print ads appeared in major daily market newspapers (i.e. Wall Street Journal) and financial industry trade publications as well as in ‘outdoor’ venues such as phone kiosks and urban panels (i.e. the lightboxes above subway stairs). This campaign won numerous industry awards⁵.

According to Ms. Bauer, the same marketing strategies that were used for the options exchange have been implemented for the Midpoint Match advertising campaign in order to attract new customers as well as remind the option exchange members that they can now trade equity on the ISE.

IV.d. One-stop shopping—good, bad, or nothing new?

One of ISE’s promises to their customers is the idea of one-stop shopping, allowing their customers to handle both options as well as equity transactions all in one

⁵ C.Malia. Personal Communication. December 8, 2006.

place. However, according to marketplace opinion, this is not a relatively new concept. Mr. Gocke has his doubts about how much this one-stop shopping feature will contribute to Midpoint's success: "I am skeptical because the NYSE makes the same argument with Archipelago. Brokerage firms have been doing this with combo orders (stock and options) for years. I don't know how valuable it [this idea] will be [to the ISE]" (Gocke). Mr. Gocke goes on to say, "What would be better and more interesting than just stock and options is an exchange that allows stock, option, and futures trading all in one place. The CBOE and the PHLX have the capability for this" (Gocke). Also, as mentioned earlier, the NYSE hopes to provide this type of exchange by adding futures to their product offerings with the Euronext merger.

In response to Mr. Gocke's opinion, Mr. Brenner brings up a very good point: "The concept of options, stock, and equity all in one place sounds great on paper, but it is very hard from a regulatory standpoint. The Securities Exchange Commission handles options and equity markets, while the Commodity Futures Trading Commission (CFTC) handles the futures markets. Midpoint Match and the ISE Options Exchange are under one regulatory infrastructure, which makes things easier." In other words, while the idea of having options, stocks, and futures all on one exchange sounds nice, the regulatory aspects do not make it so feasible.

IV.e. Not enough manpower?

Another issue that the ISE could possibly face is that there might not be enough manpower to run multiple exchanges all in one place. Recently, a second tier market of the second most liquid options classes has been added to the ISE. With Midpoint Match as another market to watch, the market operations department has now been divided into

three different divisions—the first adds members to Midpoint Match system, the second watches Midpoint Match and handles its customer service/help desk, and the third watches the options market (1st and 2nd tier) as well as handles its customer service/help desk. The question that I had to ask was does the ISE have both the technological capability and the manpower to support these exchanges as a mid size company? Mr. Caprariello gladly answered my question and cleared things up: “Yes, we do have the support because everything is monitored. Everything is automated, and should any issue occur, alerts are generated to inform Market Operations. If there are any issues, they can be easily fixed” (Caprariello). So the ISE does have the necessities to support both ISE Options as well as Midpoint Match.

V. Commentary on Recent Market Mergers and Acquisitions

With the recent market consolidations taking place in the markets, could the ISE possibly be looking into a merger & acquisition with a larger exchange? Dr. Tucker comments that older management might “cash out unless they groom a second generation” of tech experts (Tucker). He also went on to say that he wouldn’t be surprised if the ISE merges in the next few years and that he really thought the NYSE would merge with ISE.

Other market experts agree on the subject of market consolidation. Mr. Gocke points out that “there is clearly a need and a possibility for exchange consolidation” (Gocke). Mr. Gocke made an interesting analogy with regards to market consolidation and efficiency: “If Ebay is the model, there is just one market with everything and all of the sellers are experts on the products. If there were ten Ebays, it would be too complicated and cumbersome” (Gocke). Gocke continues to say that there are “natural

monopolies” with exchanges and that “competition ensures better pricing” (Gocke). If Midpoint Match develops “reasonable market share, within the 2-5% range minimum,” it will look good to other exchanges (Gocke).

Mr. Power at the NYSE agrees that there will be “more consolidation in the next few years” (Power). Mr. Power concedes that the ISE is a “great company” comprised of “really smart people who came in at the right place at the right time, and just kicked everyone’s butt in the options industry” (Power). He goes on to say “I will never underestimate them because of their success with options” (Power). He compared the ISE to the NYSE because the way that the NYSE represents the world’s largest stock exchange, the ISE is the largest options exchange. Mr. Power further agrees that should the ISE merge with or acquire a futures market, it will be similar to NYSE’s desire to merge with Euronext—simply “different twists on the same concept” of expansion. Mr. Power fully supports Midpoint Match and the ISE overall: “Based on their past track record, I wouldn’t be surprised if they make a big splash [with Midpoint Match]” (Power). The support and respect for the ISE and Midpoint Match is firmly planted in the marketplace.

On the subject of any ISE plans to merge, Mr. Brenner could not comment, but had this to say about market consolidation in general: “I am not sure if there will be much consolidation in the US; some will succeed, some will not. The options exchanges have been around for 25 years; and in only 3 years, ISE became the largest one. We can still gain market share” (Brenner). So the answer to the M&A question remains open to interpretation by market experts alike.

VI. Conclusion

The ISE started with a bang in the options industry, and has moved into equities. Midpoint Match offers unique features such as the allowance for algorithmic trading, a displayed and a nondisplayed market, a platform that matches all orders at the midpoint, and the acceptance of all trades 100 shares and above. The industry agrees that based on the ISE's past success in options in a small amount of time, they will succeed in equities. Midpoint Match can face competition with its innovative features; it is a marketable product for the ISE because it promises to make money for their customers with these features; it has the technology and manpower behind it to succeed; and it will win over their customer base with one-stop shopping.

The same brilliant and dynamic people that launched ISE Options developed Midpoint Match. Their intelligence and knowledge of the business is there. Based on how quickly they gained market share and popularity in options, they will definitely have some kind of impact on the market. Will it be on the same scale as options success? Based on the ISE's previous outstanding success with its options exchange, industry opinion says that yes, the ISE will succeed with its foray into equities. However, only time will tell the success of ISE Midpoint Match.

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