

ISE Stock Exchange Brings Dark Liquidity to Light As an 'Algorithmically Friendly' Trading Destination

Leveraging technology developed to launch an electronic, options trading marketplace in 2000, the International Securities Exchange (ISE) has expanded its reach into equities with its ISE Stock Exchange. The equities exchange debuted on September 8, 2006, in partnership with key strategic firms, including Bear Stearns, Citadel Derivatives Group, Deutsche Bank, Interactive Brokers Group LLC, JPMorgan, Knight Capital Group, Inc., Sun Trading LLC, Nomura Securities International, Inc., Van de Moolen, and a subsidiary of E*TRADE Financial Corporation. Although any sell-side firm can join the ISE Stock Exchange, ISE offers a streamlined membership process to its existing options members. More than 50 members and 17 service bureaus have already connected to the ISE Stock Exchange. ISE trades approximately 6,000 National Market System securities in its displayed and non-displayed equities market. *Global Investment Technology* spoke with Andrew Brenner, Managing Director and Head of the ISE Stock Exchange.

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IT: Would you share a progress report on the ISE Stock Exchange's non-displayed MidPoint Match equities trading platform as well as its fully displayed market since its launch?

AB: The launch of MidPoint Match was done very cautiously. We started with 10 stocks and expanded to 20, and from there grew our list. The displayed market was launched on December 8, 2006. We rolled out in December because we wanted to make sure we had all the securities up and trading, and that we would be fully functional for what at that time was the February 2007 Reg NMS date for protection of quotes.

In terms of growth of the platform, we don't differentiate MidPoint Match from our displayed market. In fact, we're most excited about the interaction of the two products. Any executable order that enters the displayed market — if a buyer wants to pay the offer or a seller wants to hit the bid — will scrape the MidPoint Match and look for price improvement. A significant amount of order flow to the ISE matches at the midpoint, as opposed to paying the offer or hitting the bid, which results in price improvement for investors.

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GIT: ISE targets 6,000 National Market System securities in its displayed and non-displayed market. What level of trading volumes are you seeing? What's the average trade size and what are the challenges to be overcome?

AB: We are currently trading about 5,800 securities, which is where we will be for the foreseeable future. We have all Reg NMS common stocks trading over \$1 and many of the exchange-traded funds as well. Our volume started out with us trading 100 shares, then 1,000; 100,000 and 1 million — then a little over 10 million shares on some days. Our average right now is in the 10- to 12 million share range. That volume is a blend of the MidPoint Match dark pool and our displayed market. The average size of our executions is very similar to other exchanges — averaging approximately 400 shares per trade.

GIT: Could you describe your business model and what distinguishes it?

AB: The best way to describe what we think about is: product, price and speed. In our product, we have the only dual-structure exchange that offers a continuous dark pool and the fully displayed market. The integration of the two products differentiates us from others and makes the ISE Stock Exchange tremendously attractive because of the flexibility of the platform.

GIT: Please clarify what you mean by a continuous dark pool.

AB: There are two types of matches. One is a point-in-time cross and the other is a continuous cross. Point-in-time crosses occur at specific times over the course of the day. Orders in a continuous cross, such as ISE's MidPoint Match, can interact at any time with orders on the other side. A continuous cross is well-suited to algorithmic trading, since matches can occur at any time throughout the course of the day.

GIT: Many buy-side orders are in the various displayed pools for nanoseconds. Would they let an order sit somewhere when the market is so agile?

AB: Our system's speed is second to none. If someone connects to us via the API, we can turn an order around in about one millisecond. If someone connects to us through FIX, we can turn an order around in about four milliseconds. Not only do we have order flow that rests on our book, we have order flow that checks our book. Because we're among the fastest or lowest latency exchanges around, people will check our book to see if they can get price improvement from MidPoint Match. We would describe our exchange as an algorithmically friendly exchange. We accept all size orders as long as they're a round lot or higher and conduct continuous crosses. Those two aspects of our market are important to the algorithmic players.

GIT: What are some of the assumptions on which you are basing this strategy to make the ISE Stock Exchange a significant competitor?

AB: There are a couple factors. First, we looked at the dark pool space and we saw that most of the products out there were broker-sponsored and many of them focused on block-size orders or on point-in-time crosses. We



Brenner: Running an equities marathon.

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differentiated ourselves by creating a platform that is exchange-sponsored, which creates a neutral gathering place that is continuous and will accept all size orders, not limiting ourselves to block orders. By integrating our completely anonymous dark pool into a displayed market, we created a unique product.

GIT: What are the special strengths of MidPoint Match and what distinguishes it in a highly competitive market for 40 or 50 dark pools?

AB: The number of 40 or 50 dark pools that is given [by consultants] is tremendously inflated. A lot of the crossing venues out there have become ATs, but frankly were nothing more than internalization before. When you get down to it, there are 10 or fewer crossing venues that attract other brokers' order flow. We're an exchange and are focused on the broker-dealer community. We're not looking to compete with our members. We're looking to work with them. [Institutional investors] must come through a member of the ISE to trade.

GIT: How can MidPoint Match to provide price discovery alternatives?

AB: We offer discovery through the displayed market and MidPoint Match offers an alternative which is the non-displayed or dark pool. Using the example of wanting to buy a stock with a bid of \$25.30 and an offer of \$25.34, you have the opportunity to find a match at the midpoint of \$25.32, and receive price improvement. MidPoint Match executions are simply based on the exact midpoint of the NBBO [National Best Bid and Offer].

GIT: What are some of the key market trends that strike you? What do they imply for the ISE Stock Exchange?

AB: Phase two of Reg NMS takes effect in July and will impact the broker-dealer community. It gives the ISE Stock Exchange the opportunity to have its quotes protected and levels the playing field with the other exchanges out there. If we have the best price, brokers or other exchanges must come to us. The other aspect of Reg NMS that is new and different is that the market data revenues are now evenly split between trade and top-of-book quotes. To date, the ISE is the only exchange that has formally filed with the SEC to share quote revenue 50-50 with our members. It's a very complex calculation, but we capture the data and we're able to do the calculation so our members can benefit.

GIT: How do you view the current landscape of competition between exchanges in view of Reg NMS and the globalization of the marketplace?

AB: With Reg NMS, the linkages have been important, the price protection is important, as well as the quote revenue sharing. Those are three aspects of the regulation that have changed the marketplace. It gives the brokerage firm the ability to look at alternative venues to place their order flow, to be price protected and to take advantage of the various characteristics that the different venues offer.

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GIT: What are your thoughts on the role of market makers? Will they always be a force or will we move to much more electronic markets where market makers are increasingly pushed to the sidelines?

AB: The electronic players are still making markets. It may be driven by a model rather than by emotion. But there's still somebody providing the input into the model that's creating the quotes. Is there a new paradigm in the marketplace? I believe so. I believe the high-frequency traders have become a very important component of price and price discovery.

GIT: Might the business model of exchanges that have market makers and a trading floor become obsolete in an age of algorithmic trading and price-time priority systems?

AB: I don't believe they will become obsolete. I believe there are opportunities for multiple styles of trading. This conversation is focused on the stock side of the business, but the options side of the business is very much a quote-driven business.

GIT: Will it become obsolete on the stock side but not on the options side?

AB: There is a little bit of a contrast between the two, but they won't become obsolete on either side by any means.

GIT: What are the prospects of side-by-side, integrated trading of equities and options, which is the core business of ISE?

AB: There are certainly synergies between the stock exchange and the options exchange. We are still evaluating the best way to integrate the two products.

GIT: What is your vision for the ISE Stock Exchange? How do you expect to develop over the next two to three years?

AB: I'll use a phrase of our CEO, David Krell, that we look at this as a marathon not a sprint. We look to steadily grow our business. We're not looking to do anything with gimmicks, but to build a sustainable business. o