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New Competitors

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New Competitors

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NEW COMPETITORS

MODERATOR
James J. McDermott, Jr.

PANELISTS
Thomas Ryan
Mary M. McDermott-Holland
Arthur Kearney
Dennis Marino
Arthur Pacheco

JAMES J. MCDERMOTT, JR.:[1]

Change in the financial services industry is occurring at a dizzying speed. When looking at change, it is important to consider the new competitive forces affecting the marketplace. Thomas Ryan will discuss the proposed merger between the National Association of Securities Dealers, Inc. ("NASD") and the American Stock Exchange ("Amex").[2] Following Thomas Ryan Mary McDermott-Holland will explain the new quantitative strategies that her firm uses to enhance its trading capabilities. Arthur Kearney will give us a preview of how market makers will handle electronic communication networks. He will be followed by Dennis Marino who will discuss future trends on the retail side of the industry. Arthur Pacheco will conclude with a presentation on Strike and what it will offer the investment community.

THOMAS RYAN:[3]

The proposed transaction between the NASD[4] and the Amex has not always been

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[1] Chairman and Chief Executive Officer, Keefe, Bruyette & Woods.

[2] *See* Cindy Skrzycki, *On the Amex Floor, a Few Cold Feet; A Vocal Minority Cites Differing Cultures in Objecting to Marriage With Nasdaq*, WASH. POST, June 21, 1998, at H01 (indicating that the Amex seat-holders must now decide if they want to become a subsidiary of the district based in Nasdag).

[3] President, American Stock Exchange.

[4] *See* Marc Ferranti, *Internet & I-Commerce*, INFOWORLD, Apr. 27, 1998, at 80 (explaining that the NASD is a self-regulatory organization that runs the Nasdaq stock market under the auspices of the Securities and Exchange Commission).

depicted accurately in the press. I will use this opportunity today to discuss the proposed merger and give several examples of how trades would be executed on the Amex.

Under the terms of the proposed merger, the Amex would become a wholly-owned subsidiary of a newly created NASD Market Holding Company, a structure that resembles the current legal relationship between the NASD and both the Nasdaq and the National Association of Securities Dealers Regulation, Inc.[5] The NASD, in a sense, will become an umbrella organization that offers its issuers a choice of markets.

Although the markets will share cost-saving technology, they will continue to trade their different lists of stocks in different ways. The Amex will remain a separate, specialist-based auction market with investor orders being matched on the floor of the exchange by a specialist.[6] Specialists will continue to buy or sell shares if needed for the 864 companies presently listed there. The Amex will also maintain its' own derivative's market. The Nasdaq will continue to be a multiple market-maker organization that trades approximately 5,500 issues. It will also remain a dealer market where market makers, by way of telephones and computers, buy shares from one set of investors and sell them to another. Market makers will continue to remain responsible for the trades of thousands of small-cap and other securities presently traded in that marketplace. This format will allow market participants to have access to the most advanced auction, dealer and options markets in the world. In addition, issuers will have a choice of being listed and traded in two separate, or distinctive, market structures – either the Amex or the Nasdaq. Moreover, issuers will still be able to freely move from one market to the other, since neither the Amex nor the Nasdaq has a requirement similar to Rule 500 of the New York Stock Exchange

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[5] *See* Skrzycki, *supra* note 2 (indicating that Nasdaq is an electronic exchange that operates as a subsidiary of NASD and is the second largest exchange in the US).

[6] *See id.* (explaining that every stock that is traded on the Amex is routed through a central firm called a specialist

("NYSE").[7]

The merger between the NASD and the Amex would result in a change in control for the two different types of Amex seat-holders.[8] The first type, comprised of 661 regular seat-holders, would receive "A shares" granting them license to act as an agent, specialist, and market maker. This entitles them to trade both stocks and options, or options only. The second type, comprised of 203 options principal members ("OPM"), would receive "B shares" that restrict their role to that of a competitive market maker in either the option business or the exchange traded fund business. OPMs would be entitled to trade only in options.

The NASD would receive a new class of stock called "C shares" that conveys control of the Amex to the NASD. The "A shares" and "B shares" would no longer have voting rights, but instead would have the right to nominate and perform certain functions internally. Since all of the voting stock would be owned by the NASD it would control the organization.

The NASD plans to invest approximately $220 million to consummate the merger. It will invest between $30 and $40 million of the $220 million in a seat repurchase program or seat stabilization fund to help compensate current Amex seat-holders for any decrease they experience in the value of their seats as a result of the merger. This initial investment would also provide liquidity if during this change some seat-holders would like to sell their seats.

The NASD plans to invest $110 to upgrade its technology. Part of this investment would go towards upgrading the Amex and adapting it to the NASD systems as soon as possible so that the Amex may begin running its platforms off of the NASD platforms. Another part of this

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who is responsible for matching buy and sell orders).

[7] Rule 500 prevents unscrupulous management from delisting from the NYSE by requiring a company to obtain a two-thirds majority shareholder vote before it can leave the exchange. *See* Paul Beckett and Greg Ip, *SEC Asks Big Board to Go Further in Proposals to Make Delisting Easier*, WALL ST. J., June 1, 1998, at C21.

investment would be used to ensure that efficient service technology is implemented so that orders are efficiently transmitted. The Amex will pay for these technological improvements through a pay-per-use arrangement with Nasdaq. Under this arrangement, $50 million dollars worth of upgrading will allow the Amex to access Nasdaq's superior technology without having to invest in creating their own systems.

An additional $30 million would be spent a new promotional program by the NASD called the "market of markets." This program will promote the viable and efficient alternatives that will have resulted from the combination of the Nasdaq and the Amex. It will also highlight the ability that issuers now have to choose the structure in which they would like to be traded.

The Amex will incur an additional $50 to $55 million in costs by merging with the NASD because redundancies between the two organizations will lead to severance costs. In addition, the Amex will incur transaction costs particular to the deal, such as legal and banking fees.

The Amex's governance structure would also change as a result of the merger. Four members of the Amex board would also become the NASD board, two independent members of the NASD board would become members of the Amex board and one staff person and one floor member would join the NASD board. The Amex would retain its own board of directors because it is both a self-regulatory organization ("SRO") and a stock exchange. The Amex board is presently composed of twenty-six members, which will soon be reduced to eighteen. In the new structure, the eighteen will be composed of four staff members, (two coming from the NASD and two coming from the Amex) four floor members, and the remaining ten seats consisting of a combination of industry and independent directors.

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[3] There are 864 corporate and individual seat-holders that own the right to trade on the floor of the Amex exchange.

The Amex's and NASD's market structure would also change as a result of the merger. Mergers in this form come about from the desire of the entities involved to increase their competitiveness. After merging with the Amex, the NASD would be more competitive because of its ability to allow issuers to choose the market structure in which they would like to trade. In addition, the merger will introduce the NASD to the options business, where they are currently not competitive. The specialist-based auction market structure will remain largely intact and the Amex needs to only spend a portion of the money allocated for technology to upgrade its technical tools.

Additional changes include the Amex's proposal for a new equity market structure. While retaining a specialist order-driven central auction market, the Amex plans to implement three changes that the investment community has indicated that it would like an exchange to institute. The first change would be the introduction of the Post Execution Reporting ("PER")[9] system, which operates in a similar manner as the Designated Order Turnaround ("DOT")[10] system used by the NYSE. The difference is that, contrary to popular belief, these are not automatic execution systems. With a true electronic execution system, the Topeka office of Paine Webber, the block desk of Goldman Sachs, or any similarly remote trading office will have a terminal that will allow the user to view the bid and the offer. The PER terminal will also allow users to submit an order, creating the exclusive right to interact with the posted bid or offer. For example, a given stock with ticker symbol XYZ is 40,000 shares bid and a trader or

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See Skrzycki, *supra* note 2.

[9] Through the use of the PER system, member firms are able to electronically send equity orders directly to the specialist's post for execution and reporting. *See Amex Wants Larger UIT Orders to be Sent on its 'PER' System*, SEC. WK., Apr. 5, 1993, at 4.

[10] *See* Ivy Schmerken, *The Bulls and Bears Come Out at Night; Electronic Trading*, WALL ST. & TECH., Sept. 1, 1990, at 14. The DOT system, developed in 1976, is the computer system used by the NYSE to route orders to the specialists handbook.

other user of the system wants to sell 38,000 shares. He enters the order and instantaneously has sold 38,000 shares. Both the specialist and the crowd have read about it. No one saw it until they looked up on the tape or their inventory changed. This involves real automatic execution rather than mere order entry into an auction.

The second change the Amex would implement would be to eliminate floor brokerage on all electronic traffic. It does not matter whether a system user enters a million-share bid or a hundred-share bid, nor does it matter whether the bid occurs over two minutes or seventeen days. The Amex will have no floor brokerage for all orders that are entered through the electronic system from a remote location.

Finally, the Amex would provide significantly increased transparency, beyond what stock exchanges have historically done. The Amex will display the bids below the posted bid and will display offers above the posted offer. Many people in the industry have asked consistently to look at the specialist book. The Amex will now display the specialist book, and it may be viewed from terminals at the upstairs firms.[11]

Though not directly related to market structure, the Amex simultaneously plans to significantly reduce its Tape B fee. This will result in significant savings on an annual basis to its Tape B subscribers, who generally consist of the large order flow firms and investment managers.[12] For instance, with electronic execution, if a user pushes a button, he has the exclusive right to interact with a quote, post a bid or offer, and have the right to transact for up to the smaller of the size of the order or the size of the bid or offer. If 30,000 shares are bid for and

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[11] *See* Skrzycki, *supra* note 2 (noting Gene Lopez's prediction that in the wake of the merger and restructuring, Amex specialist's books of pending orders will be made visible to traders at remote locations).

[12] *See* Greg Ip, *Amex Warns it May Fall Behind Rivals if Merger With NASD Isn't Approved*, WALL ST. J., May 19, 1998, at C1 (noting plans on the part of both the NASD and the Amex to implement reduction of Tape B fees in the event the merger is consummated).

the user has 40,000 to sell, she has the exclusive right to sell that 30,000. If 40,000 shares are bid for and the user has 30,000 to sell, she has the right to sell 30,000. The number of shares in the transaction will always be the smaller of the two.

The user may also trade from a remote location, either from a branch office, or from a professional trading desk of a member firm. One does not enter an auction, which does not provide the execution price of the order, until later. Instead, an audit trail exists wherein the process is electronic and takes only microseconds.

To illustrate, I will give two examples: one is incredibly simple and the other is somewhat more complicated, although, a caveat exists in that the Board and SEC must approve the market structure. For my first example, I will describe a simple automatic execution. This simple automatic execution includes an electronically entered market order trade against an electronically entered limit order on the book. The trade will be completed between member firms without a specialist or broker involved. Initially, a limit order to buy 5,000 shares of XYZ stock at a price of $20 had been electronically entered by Goldman Sachs. Also entered was a similar limit order to sell 5,000 shares of XYZ stock at a price of $20 2/16 by BT Alex Brown. Other limit orders entered above that offering and below that bid, or outside of the quoted market, were also on the Book.

What the system user would see on his terminal screen is that the market is $20 to $20 2/16 and 5,000 shares either way. Looking at the middle of the screen, there is that $20 bid by Goldman Sachs and there is that $20 2/16 offering by BT Alex Brown. Looking below that offer, there is nothing bid at $19 15/16, there is 1,000 bid for at $19 14/16, 2,000 shares bid for at $19 13/16, and 5,000 bid for at $19 12/16.

Above BT Alex Brown's bid posted offering, the following orders are also posted on the

book. They may have been put there manually or they may have arrived electronically. That is irrelevant. The only important information is that at $20 4/16, for example, there are 3,000 shares offered.

This picture of the stock is not as complete as the one a user could get by going to a specialist post and having a broker inquire into whether crowd traffic or indications exist. Nevertheless, the system user is able to see priced and sized orders that are close to the market.

Return to the scenario where Goldman Sachs is bidding $20 for 5,000 shares of XYZ stock and BT Alex Brown is offering 5,000 shares of XYZ stock at $20 2/16. Consider further a scenario where Merrill Lynch, from its Cleveland office, electronically enters a market order to buy 5,000 shares. In a matter of microseconds, this order would arrive at the stock exchange and Merrill Lynch would receive an automatic execution at the quoted market of $20 2/16. This transaction represents the offering side of the market. The amount is posted in the book as a function of the BT Alex Brown limit order entered previously, whether occurring three minutes or three days ago, and 5,000 shares would trade at $20 2/16. The system would then either automatically generate a new quote based upon the book or modify the quote by the amount executed, depending upon the buyers and sellers in the crowd or whether the specialists want to do something bigger or tighter. This then becomes a very simple trade.

On the left, this picture shows you what the marketplace looked like

I will now demonstrate an example of how the system would work with a more complicated scenario. In this system, there are still brokers, manual orders, and working orders. Now, however, they are all integrated. Consider a scenario in which someone attempts to match orders in an environment in which the book contains electronically delivered orders that are both priced and sized, as well as buyers and sellers in the crowd.

My second example involves a market order to buy a quantity of shares that is larger than the number of shares offered at the lowest quote. I will assume that this trade would require a three-part execution with matching. The participants for this trade are a buyer, a specialist, two brokers in the crowd, and other sellers reflected in the order limit book.

When a market order is placed for a quantity of shares that is larger than the number of shares bid or offered, part of that order will first trade automatically with the lowest quote offered in the book. The unexecuted portion of the order will be subject to a brief pause of no more than fifteen seconds. Simultaneously with the initiation of the pause, the quantity of shares on the offer side of the book will be reduced. At this point, the specialist will have the right to step in to trade with all or part of the order, at a price better than the impending new market price. If the market order remains unfilled at the end of this pause, the limit book will be modified to reflect the new market. Finally, the unexecuted portion of the market order is filled employing matching guidelines to allocate shares between sellers with offers in the book and sellers among interested brokers in the crowd at the trading station. The following figures detail this step by step process.

In this example, the book is the same as in the first example. Goldman Sachs had submitted an electronically entered limit order to buy 5,000 shares of XYZ stock at $20. The offering side is the same, with an electronically entered limit order to sell 3,000 shares of XYZ stock at $20 2/16, submitted by BT Alex Brown some time ago. Additionally, from upstairs, it is evident that other limit orders were offered outside of the quoted market registered on the book. The closest one on the sell side is a limit order to sell 5,000 shares of XYZ at a price of $20 3/16. This appears to have been entered some time previously by Smith Barney. Finally, there are two brokers standing in the crowd with their interest not represented in the quoted market because

they have not declared themselves. They too may want to buy XYZ stock, depending on the trades. This example demonstrates a typical scenario that can arise in the central auction market.

If a user of the system were upstairs, this is what he would have seen. The market is $20 to $20 2/16, 5,000 to 3,000, with offers for 5,000 at $20 3/16, and bids for 1,000 at $19 15/16, and so forth.

In this example, Merrill Lynch wants to buy 7,000 shares. This order is clearly larger than the offering side of the market. We know, having looked at the quote and at the book, that the book cannot complete the order because the offer is smaller than the buy order.

So, when Merrill Lynch electronically enters its market order to buy the 7,000 shares of XYZ stock, it would receive an automatic execution at the quoted market price of $20 2/16 for the first 3,000 shares. This would only happen if the offering side of the market makes an offer of 3,000 shares at $20 and 2/16. This leaves a 4,000 share unexecuted balance of the 7,000-share order. The system places this balance into a mode called pause. In general, this will allow corresponding offers either to buy or to sell ("contra interest") to interact with the unexecuted portion of the electronically delivered order. Corresponding offers to sell will have the chance to interact with the unexecuted balance of Merrill Lynch's order while the order is in pause mode. Simultaneously, the system automatically modifies the displayed quote by the amount executed. An exact number of seconds has not yet been defined for the pause, but it will be the smallest number necessary and will not exceed fifteen seconds. The order would remain open for a maximum of fifteen seconds before it would be matched with the lowest offering.

The order would remain unexecuted for several seconds so that if a seller were present in the crowd who wanted to complete it at the original transaction price of $20 2/16, that seller would have the opportunity to do so. This in turn would provide price improvement to the

electronic buy order.

When the 3,000 shares of XYZ stock traded at $20 2/16, the system automatically generated the new quote. This is a bid for 4,000 shares of XYZ stock at $20 2/16 and is the balance of the 7,000-share order. The offer of 5,000 shares at $20 3/16 submitted by Smith Barney remains on the book. The rest of the book remains as it were before the partial execution. The 3,000 shares previously offered at $20 2/16 are gone because Merrill Lynch bought that block as part of its 7,000 shares order. This left them bidding for the remaining 4,000 shares at $20 2/16.

During the pause, the specialist sells 2,000 shares as principal against the unexecuted portion of Merrill Lynch's market order. This may take place for one of any number of reasons. The specialist does this in reaction to the fact that there is no contra interest at better than the quoted market. He is permitted to do so because such a trade provides quantity improvement. The specialist may therefore execute such a trade at any time he chooses. The system now shows that Merrill Lynch's order to buy 7,000 shares at $20 and 2/16 remains unexecuted in the amount of 2,000 shares. Smith Barney's 5,000 shares are still offered at $20 3/16.

Recall, however, that two brokers were also present on the trading floor. As it turns out, they are sellers whose reputations may rest on making a sale. Five thousand shares have traded at $20 2/16 and they have done nothing. As is often the case in the central auction market, they each decide to sell something while the stock is still trading at $20 2/16. Each decides he wants to sell 1,000 shares so both enter the auction by offering on the book at $20 3/16.

Under the central auction market rules, if a clearing sale takes place those brokers are allowed to match with the other sellers. In this case, two sales took place: one for 3,000 shares at $20 2/16, the other for 2,000 shares at $20 2/16. In this particular instance, the other sellers were

on the offering side of the book. The two brokers add themselves to the book and the book becomes the Smith Barney order plus the two brokers' offers to sell. The book goes from 5,000 to 7,000 shares on the offering side, with each of the sellers having added 1,000 shares to the offering side of the market.

The Amex has in place matching guidelines that address a situation such as this. When a situation exists in which more than one entity wants to offer at the same price, these guidelines allow all offerors to share in a fair and equitable manner. Our present splitting system is a sharing system, which is quite similar to an auction. Under the present system, if a stock trades at $20 3/16 the original order on the book should get 60 percent of it. This is true even if the order is much smaller. Additional offerors may then share the balance.

In this particular case, if the stock were to trade at $20 3/16, the Smith Barney order would get 60 percent of the trade. The two brokers who decided they wanted to sell their stock for that price would share the 40 percent. The 2,000 shares remaining might ultimately trade at $20 3/16, which the system would offer after the fifteen-second period has expired. Smith Barney would sell 1,200 shares, while the two brokers would split the remaining 800, probably getting 400 shares each. This would then complete the unexecuted portion of Merrill Lynch's order. The system would then automatically modify the displayed quote by the amount executed.

MARY MCDERMOTT-HOLLAND:[13]

The topic, New Competitors, brings to my mind two questions: who were the old competitors and what has become of them?

My work involves both domestic and international trading. A few weeks ago, I was presented with a multi-country program. I called up UBS Securities, Inc. and asked them to make a bid on the program. They replied, "We were just taken over by SBC Warburg Dillon Read and our department is in flux. We are not sure that we are going to be here tomorrow, but we will make a bid." In response, I said, "Well, do not bid on it if you are not going to be there tomorrow to trade it."

My second call was to BZW Securities, Inc., which had recently been bought out by Barclay's Bank.[14] Their whole program trading department left to join Nomura Securities. Consequently, I called Nomura Securities. They too were in a state of restructuring. The people there with whom I had once dealt were also gone.

My last call was to NatWest Securities. They were currently restructuring with DMG Securities, Inc. Their restructuring led to layoffs.

What does this progression demonstrate? I believe it demonstrates that the old Pac Man game is active in today's market. Heavy consolidation is causing new competitors to swallow up the old competitors. Examples include (1) the merger between the NASD and the Amex, and (2)

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[13] Vice President of Trading, Franklin Portfolio Associates, Boston, MA. Ms. McDermott-Holland is responsible for all traditional, quantitative and international trading. She is currently a Governor of the Security Traders Association ("STA"), Chairman of the STA's Conference Committee, former member of the STA's Institutional Committee, a member and former Chair of the Electronic Products Advisory Committee to the Boston Stock Exchange, and a member of Trader Forum's Advisory Committee. She is also Treasurer of the Boston Securities Traders Association, a member of the National Organization of Investment Professionals, a member of the Institutional Traders Advisory Committee to the board of the New York Stock Exchange, and has served as President of the Boston Securities Traders Association. She has an AAS degree from Newbury College.

[14] *See Polls of Poll, Battling to Join the Elite,* EUROMONEY, Jan. 15, 1998, at 68. Credit Suisse First Boston has since

the formations of Salomon Smith Barney.

This consolidation trend shows no sign of slowing down. Even the investment funds are not immune. Consider the mergers of AIM Management Group, Inc. with Invesco, and PLC with the Zurich Group. The Zurich Group owns load-based Zurich Kemper Investments, Inc. and soon will own Scudder Stevens & Clark, Inc. These are some of the issues and problems existing in today's environment. I am pleased to be here today representing the buy side. Let me tell you about our firm, how we do business, and what we are looking for down the road.

Franklin Portfolio Associates is a Boston-based investment management subsidiary of Mellon Bank. Please do not confuse us with Franklin Management or Franklin Resources, who deal with mutual funds. Established in 1982, Franklin Portfolio Associates began as a firm of only five people. As of March 1998, the firm consists of twenty-two employees, handling about $16 billion dollars worth of transactions. This includes $1 billion of overseas money, plus another $5 to $6 billion of small to mid-cap money.[15] Our client base consists of twenty-two clients and forty accounts, covering 4,000 securities. As a result, our firm can manage multiple styles per client, and can support very diverse needs.

Allow me to give you some statistics on our firm. Our trading volume last year was 120,000, which amounted to approximately $26 million in commissions at an average rate of $0.035 per share. This translates to approximately $28 billion traded, which has an average turnover of approximately 80 percent or 880 million shares.

Franklin Portfolio Associates functions as a quantitative trading and management firm.

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acquired BZW's equity and merger and acquisition's interests from Barclays. *Id.*

[15] BARRON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS 538 (4th ed. 1995). Small cap is shorthand for small capitalization stocks or mutual funds holding such stocks. Small cap stocks usually have a market capitalization of $500 million or less. *Id.* This is computed by taking the number of shares outstanding multiplied by the stock price. *Id.* Small cap stocks represent companies that are less well established. *Id.* Faster growing companies have more mid-cap

We look to enhance our trading with a strategic blend of crossing systems and portfolio management services. Pursuant to our quantitative strategy, we use multiple indices as our benchmarks. If an opportunity exists that fits our strategic style and performs well against our benchmarks, we will book the trade.

The ultimate goal for my own trading desk at Franklin is to reduce both trading and opportunity costs. This results in increased performance. I feel that the 450 basis point[16] differential between a five-star and a two-star rating[17] is attainable when we go out and market our capabilities.

Plexus numbers usually average 100 basis points for the large caps. This differs from ours, which run about fifty basis points, so we are getting the job done. On the small-cap side, we run approximately 180 basis points.

By decreasing trade and opportunity costs, we are able to increase performance. This results in happier clients. In addition, greater efficiency in how we operate will lead to increased revenue for our firm because a majority of our clients are charged performance-based fees.

We currently use MacGregor's Predator Trade Order Management System.[18] This allows us to benefit from the use of cutting edge technology venues without incurring the significant costs of constructing our own system. Because our firm is small and because we do not employ

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stocks, ranging from $500 million to $3 or $5 billion. *Id.* Companies may also have large cap stocks with prices ranging as high as a billion or more. *Id.*

[16] A basis point is the smallest measure used in quoting yields on bills, notes and bonds with one basis point is equal to .01%, or one-hundredth of a percent of yield. *See id.*

[17] "Morningstar's rating system is designed to illustrate the relative attractiveness of a fund's risk reward profile." *See Wall Street, California: Time For a Tuneup How to Read the Funds List,* L.A. TIMES, Sept. 30, 1997, at D11. Funds in "the top 10% of a given class for a given period are awarded five stars; the middle 35% earn three stars and are classified as neutral; and the next 22.5% receive two stars, which is below average."

[18] "The Predator Trade Order Management System is focused on buy-side firms through trading, portfolio modelling and management and compliance functions." *See* Michael Dabaie, *OptiMark Inks Agreement to Connect Predator,* SEC. INDUS. NEWS, May 4, 1998, at 8.

a large in-house technology department, we have limited technological development resources compared to our larger competitors. Therefore, the benefit we get from using this outside system is significant.

I envision that the trade order management systems will play key roles in the investment management environment. These systems will provide several advantages. They will eliminate the need for portfolio managers to manually buy shares of stocks across their accounts and for traders to do manual calculations on trades. Further, the systems will provide an important venue for brokers and service providers, because such systems remove the burden of technological development.

The rate at which technology changes will only continue to accelerate. Just last year we were not on-line with any financial information exchange ("FIX") facilities. By the end of March, however, we had twelve FIX links in place. Six of these links reveal indications of interest, while the remaining six allow us to send and receive order flow and executions.

The productive effect of FIX technology can be described through the following example. Consider a trading desk trading our typical volume. Because of our limited staff (only 2 traders until last October, now three), our traders never had the time to take calls or view merchandise.[19] We were consistently missing out on potentially valuable information. Calls from twenty different brokers with fifty different stocks might yield only one stock that the trader had an interest in. So, the amount of administrative time spent fielding phone calls for one stock served as a self-defeating proposition.

The FIX product allows us to streamline this process dramatically. We now take

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[19] *See* Edward Kountz, *Thinking Globally, Acting Locally: How Technology Shaped Putnam and Vice Versa*, SEC. INDUS. NEWS, Aug. 25, 1997, at 11 (explaining how the FIX is a standardised messaging protocol that provides all-electric connectivity between the executing broker and the portfolio accounting system).

indications from any broker, let the indications filter to our trading blotter, and populate the field in only those stocks that we are actually trading. The FIX product adds value by providing meaningful information to our trading desk, without consuming our traders' time answering calls. This provides traders with the vital time needed to find the optimal liquidity[20] for a particular stock.

All brokers who have not implemented FIX should strongly consider doing so. Implementing the FIX product could potentially require a great deal of work with the different trading system providers. We believe, however, that the resulting increased business from buy-side firms far outweighs the costs.

Now that I have discussed the benefits of using FIX technology, I will present where and how Franklin trades. We trade with many, but not all, systems. We do trade with QuantEx, ITG's Portfolio System for Institutional Trading ("POSIT"),[21] Instinet's Order Management System ("OMS"),[22] the Arizona Stock Exchange ("AZX"), Lattice,[23] Nasdaq wholesalers, boutique firms, direct floor access firms, large houses, and program trading firms on a principal bid and agency basis. Overseas, we trade active, multi-country programs, and crossing orders.

We attempt to be very selective in the systems with which we trade. Consequently, we never participated in the NYSE Match, because it was not an anonymous system nor did it fit our

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[20] *See id.*; *see also Cedel's Liberty Chalks Up Clients in United Kingdom*, SEC. INDUS. NEWS, Feb. 9, 1998, at 11.

[21] *See* Jon Birger, *Maker of Wall Street Systems Hopes to Trade on Sale of Stake: Deal Will Spotlight Strong but Quiet ITG*, CRAIN'S N.Y. BUS., Apr. 13, 1998, at 4 (explaining how POSIT is a widely used electronic system that anonymously matches buy and sell orders of large investors); *see also* Polly Nyquist, *Failure to Engage: The Regulation of Proprietary Trading Systems*, 13 YALE L. & POL'Y REV. 281, 303-304 (1995) (stating that POSIT allows investors to trade both complete portfolios and single issues of stock).

[22] The OMS is a type of contact-management software that can be used in a sales setting to act as a lead distribution system for various groups of users in a sales force *See* Jeff Walsh, *Maximizer Bolsters Contact Management*, INFOWORLD, Mar. 2, 1998, at 38.

[23] *See Lattice Warns of Shortfall*, FIN. POST, June 11, 1998, at 12. Lattice makes programmable logic devices that can be easily adaptable for use with a variety of telecommunications and networking equipment. *Id.*

strategy. For similar reasons, we did not participated in the Chicago Match.

I examine many factors when evaluating a new competitor. First, I consider whether the type of advanced technology within its possession is compatible with our business, and what additional functionality could be provided to us.

Next, I consider whether the competitor has made a commitment to the product or service. I have people beating down my door every day with program trading opportunities. I finally submit, go to them and say, "Okay, I will give you a program." They respond, "Those people do not work here anymore. We have changed the whole department." That happens a lot. Accordingly, our concern is whether the competitor has made a commitment to its business. This is a big problem, for me at least.

Next, I consider whether there is an integration issue. I also consider whether there is anonymity with the access products. Does it provide me with a free choice? Can I control my orders? What are the barriers to entry?

Finally, I consider whether the service is tied to something else. For instance, unless you are a Bloomberg user, you have to buy the Bloomberg quote system to be able to access Bloomberg's TradeBook; this is a barrier to entry. Another example is the new Nasdaq limit order file. Using this, you can trade only as an institution with a primary market maker, which cannot be clearly defined today. Furthermore, because problems inherently exist in that particular system as well, how do you trade with every stock?

Accordingly, the question of who will dominate is an interesting one. Certainly if I knew who could answer that question, I would be banging down their door looking for a job. Big banks seem to be a buying presence, with technology companies giving them the means and know how. Brokerage firms also seem to, or try to, provide it. Competitive pressures will

dictate which crossing systems will ultimately dominate. The leaders include Instinet, Tradebook, Strike Technology, or a combination of all these services. Only time will tell.

ARTHUR KEARNEY:[24]

I represent the lowly market makers at this symposium. In this area, the competition is changing rapidly. Evidence of this is demonstrated with the recent merger of Dain Rauscher Corp. with Wessels, Arnold & Henderson LLC and with Piper Jaffray being taken over by U.S. Bancorp.[25]

I work for John G. Kinnard & Co. ("Kinnard"). We are a small, regional firm that employs 150 retail brokers. I head the Equity Capital Markets ("ECM") group. The ECM group is composed of a research department that has nine analysts and a corporate finance department. The ECM group also includes an institutional sales department and a Nasdaq trading department. We trade approximately 300 stocks with eleven position traders - down from the 425 stocks we were trading a year ago when we had fourteen positional traders.

Kinnard will commit anywhere from $5 to 6 million dollars a day. While some in the industry may not think this is a significant amount, I do because I am looking at the positions from the viewpoint of capital markets. I believe that a firm's trading constitutes only one segment of an integrated organization's dealings.

Most industry insiders would say that the Electronic Communication Networks ("ECNs")

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[24] Executive Vice President, John G. Kinnard & Co., Minneapolis, MN. Mr. Kearney is also the Director of Equity Capital Markets and a Senior Vice Chairman of the STA.

[25] *See* Jill J. Barshay, *Dain Rauscher to Buy Investment Bank Wessels; $150 Million Deal Continues Trend in Industry*, STAR TRIB., Feb. 10, 1998, at 1D (discussing the recent flurry of mergers and the coupling of investment banking with distribution).

and Crossing Networks are the new competitors.[26] These include Reuter's Instinet, ITG's POSIT, Nasdaq's Small Order Execution System ("SOES"), and Nasdaq's SelectNet. However, these systems have existed for years. In the past, brokerage firms could afford to send substantial checks to Instinet and others. Also, I imagine that most firms have horror stories about SOES. Many firms lost a great deal of money trading on SOES, or "got SOES'ed". Nevertheless, brokerage firms could absorb those losses because they had other trading order flow that allowed them to make a profit.

Now our margins no longer allow us to absorb these costs. The new rules for ECNs, allowing them to charge market makers and the new Order Handling Rules ("OHR"), as well as more costly systems that firms have had to install because of the new regulations have reduced our margins.[27] Not all of the new regulation is bad. The new trading increments are beneficial to many customers. However, in the past, when we took a loss we were able to make it back. Now, there is really no way to recover those losses.[28]

Ultimately, the trading market will be divided between two different types of firms. The first type will include large wire houses or market makers. These firms will collect order flow and use technology systems to trade the order flow. They will be comprised of a consortium of broker-dealers who get together and combine their order flows. Knight Securities conducts business in this manner and provides a good example of this process.[29]

The second type of firm includes firms that trade only the stocks they have researched

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[26] *See* Matthew Schifrin with Scott McCormack, *Free Enterprise Comes to Wall Street*, FORBES, Apr. 6, 1998, at 114 (stating that ECNs are shaving away business from giant market makers and narrowing spreads).

[27] *See* Final Rule: Order Approving NASD Rule Change Relating To Implementation Of Commission's Order Handling Rules, Release No. 34-38156, *available in* 1997 WL 9324 (S.E.C.) (Jan. 10, 1997).

[28] *See* Schifrin, *supra* note 26 (explaining that big market makers with high overhead cannot make money with narrowing trading spreads).

[29] *See* Deborah Lohse, *Will New Rules Affect Smallest Issues' Liquidity?*, WALL ST. J., June 9, 1997, at C1. Knight Securities is a Jersey City, N.J. wholesale firm that trades with other dealers as well as with retail brokerage firms. *Id.*

and can rely on. Examples of this type of institution include Merrill Lynch, Paine Webber, Kinnard and others. Their strategy is based more on an effort to maintain a beneficial client relationship. Firms that have a retail business have begun to examine this component and have discovered that some retail trading is no longer profitable.

How does this affect the ECM group? Regulators, and those who write the rules, treat trading as though it is a one-dimensional object. Indeed, in most firms trading is part of the ECM group; however, regulators incorrectly assume that the profits are disbursed directly to the traders. It is simply not true that when the month ends, if a firm has made $100,000 in trading profits and has four traders, each trader receives $25,000. Instead, many firms take the trading profits and invest them in research and banking. Firms realize that these departments drive many deals that create additional stocks to trade. This is the approach that Kinnard embraces. I believe that many other firms take the same approach.

Without these trading profits or gross commissions firms will be forced to consolidate. This is evident even now. As firms build huge ECM groups, the economies of scale will no longer be able to do $30 million deals. Firms will have to deal in the $50 million range. This will result in mergers such as the $1.2 billion acquisition of Montgomery Securities by Nations Bank.[30]

Another effect has been the formation of many orphan companies. Orphan companies are primarily regional companies that were brought public, traded, or sponsored by the brokerage firm. Today, after mergers and market capitalization changes, many analysts no longer cover these orphan companies, and many small regional firms have lost their sponsorship. These small

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[30] *See* Andy Zipser, *Review & Preview*, BARRON'S, June 30, 1997, at 12 (noting that the "urge to merge" continues among financial institutions).

firms need analysts to bring attention to their stocks. Without that attention, small firms do not grow, and their ability to raise capital in the public market is limited. This dynamic is a key part of anyone's ability to raise money in this country.

On the other hand, orphan companies create opportunity for firms like Kinnard, the smaller firms, and for those firms that may be in a different niche. As more firms continue to consolidate, additional voids will be created that the smaller firms will fill. Although more opportunities are suddenly emerging on the banking side, those involved in the industry know that banking can dry up very fast. In contrast, trading does not turn on and off. Its movement is more constant, which makes it more reliable than banking.

The consistency of trading is important because firms will begin scaling back their trading operations. These firms can no longer afford to make a market in a stock in which their opportunity for return on capital is in doubt. This will not change until a market maker is able to commit his capital as he wishes. Thus, it is very important that the actual size rule pass. A market maker's decisions where to place his capital, and who should receive it, must be recognized as business decisions.

Our chief competition is neither discount brokerage, wire houses, nor wholesale trading operations. We have competed successfully and profitably with those areas of the industry for years. Our real competition today is the playing field that has been created - the market that tells us when to commit our capital, how to commit it, and to whom.

This market mandates best execution. While that rule is necessary, and market makers agree with it in principle, the market maker gets charged for complying with it. The rule subjects the market maker to regulatory fees. Although the initial intention presented a beneficial result,

market makers now get double-dipped with Section 31(a) transaction fees.[31]

These are just a few of the problems market makers face. They add up to a substantial portion of our profit margin. And recently they have begun cutting into our return on capital. When senior management of brokerage firms start to examine their return on capital and discover that it is not up to plan, they will scale down or shut down the firm's trading operation.

Market makers are also subject to constant rule changes. While some of these rules benefit the customer and the firms, others have unintended consequences. It will take action from Congress to fix this situation. Generally the industry has been very unsuccessful in trying to alter the market's effects on the market maker. This leg of the ECM must be fixed, or firms will have tremendous difficulty raising the capital needed to go forward.

Perhaps in a couple of years the "system of the future" will arrive. This will most likely be NAS/INSTA/POSI/OPTI/DAQ. Considering the pace at which the industry continues to change, this representation will be your market for the next thirty minutes.

DENNIS MARINO:[32]

I have spent most of my life at Sherwood Group Inc. as a wholesale market maker. Recently I moved to the retail end of the business, National Discount Brokers Inc., an affiliate company of ours. I thought I would spend some time today not necessarily talking about National Discount Brokers, but what could conceivably be viewed as our competition, online trading. There is, as I believe everyone here is aware, at least one online trading firm that is

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[31] The SEC to recover costs to the government relating to, inter alia, the supervision and regulation of securities markets collects section 31(a) transaction fees. Securities Exchange Act of 1934, " 31(a), 15 U.S.C. " 78ee.

[32] Chairman, Chief Executive Officer and President, National Discount Brokers. He is the Chairman of the STA's Political Action Committee and a member of the STA's Executive Committee.

currently allied with an ECN.

I would first like to discuss current developments in the Internet, looking at them from the discount brokerage end. Particularly, I would like to focus on online trading, which I have had to learn a fair amount about in a fairly short time.

There is absolutely no question that we are in the midst of an emerging digital economy.[33] Ours is a progressively more self-directed, "Home Depot" generation that, in a sense, has embraced the poignant Nike tag line: "Just do it." They seem to believe it is possible to take increased control over managing their own wealth and investment decisions. They are assuming that control in addition to, and in a lot of cases instead of, relying solely on traditional brokers for advice.

What has really happened, as I am sure everyone is aware, is that information today is ubiquitous: it is everywhere, twenty-four hours a day, seven days a week, virtually anywhere in the world. As a result, an investor who wants to gather research may now use free sources, available to everyone, that previously had to be purchased through a broker or a professional advisor. There is no doubt that these tools have changed, and will continue to change the consumers' investment patterns.

Recently, there has been an unprecedented rush into cyberspace. Last year, 100 million people logged onto the Internet, which is up from 40 million the year before. To put the trend in historic perspective, radio and TV took thirty-eight years and thirteen years, respectively, to have

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[33] *See* Commerce Department Releases Report Assessing the Digital Economy, 17 NO. 9 BANKING POL'Y REP. 3 (1998); see *also* Bruce Ingersoll, *High Tech Industries Led by Internet, Boost U.S. Growth and Rein in Inflation,* WALL ST. J., Apr. 16, 1998, at B9. The Commerce Department's first report on the "emerging digital economy" states that commercial Internet traffic, not restricted to the area of securities, doubles every 100 days as online purchases by firms and individuals soar. *Id.*

50 million people tune in.[34] The Internet has, in four years, already surpassed 100 million, and I am sure everyone is aware that this number is growing by leaps and bounds.

Four years ago, there were no online trading firms. Today, there are approximately sixty-two, and there will surely be more within a few months.[35] While in 1997 seventeen percent of all retail trades were done online, in 1998 online trading is predicted to constitute over 30 percent of all transactions.

A third of all discount commissions are currently done online. There are approximately 3 million customers that trade online, which represents about $100 billion under management. In four years that number is predicted to grow to 15 million customers trading online, controlling approximately $700 billion under management. There is no question that the trend will continue. Thus, the Internet is here to stay, and is going to change profoundly how we do our business. To a large extent, it already has.

Let us consider some of the significant developments that have gone on in the online brokerage area. It is probably apparent to everybody that there has been a fierce, "take no prisoners" attitude toward price competition. I would humbly suggest that this is the result of a company named National Discount Brokers. Four years ago, National Discount Brokers decided that they had what they considered a better idea. The idea was to provide customers with a flat fee for any trade. When we launched the concept we really had no idea how revolutionary it would be. Today, there are a number of financial service providers who are doing the same thing with a slightly different spin. These are not just discount brokers. Some major wire houses use a

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[34] *See* Ingersoll, *supra* note 33.

[35] *See* Testimony of Frank Kelly, Vice President, Charles Schwab Co., Inc., before the Senate Finance Comm., Congressional Testimony, July 16, 1998, at 1 (discussing the growth of the Internet and the various tax and trade issues of concern to the online brokerage industry).

version of the flat fee.

When we first launched National Discount Brokers, our clients were charged a flat fee of $30 per trade. In the past year, commissions have declined over 55 percent. The median rate a year ago was $35; today, the median rate is $15, dipping as low as $5. I suspect that sometime in the near future, investors will be able to trade free of charge, with some restrictions. There are even some who suggest the possibility that in the future, these services may be willing to pay customers to enter an order.[36] I do not think that this scenario is totally out of the question.

There has also been a frenzy of advertising. There is currently a "land grab" for market share. I am sure everyone is aware that over the past year or so advertising has grown dramatically. I think it probably started with E-Trade, but today you cannot turn on your TV without seeing an ad from Ameritrade. The strategy is to gather as much market share as possible, at almost any cost.

In the last quarter, Ameritrade spent $25 million on advertising. This is a significant number by any measure, but is particularly large for a deep discount broker. We have also started to see a higher profile from less traditional discounters, like Datek and Web Street, both of which have made significant inroads into online brokerage.

The other significant factor that had a dramatic impact on discount brokerage is the reduction of payment for order flow.[37] The trend has forced everyone in our end of the business to reexamine their business models. Payment for order flow previously accounted for a significant portion of bottom-line profitability. However, it has been reduced by more than 50 percent in the past year. Some think it will stabilize or even decrease, but I am not sure that it

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[36] *See* Suzanne Woolley, *Do I Hear Two Bits a Trade? – An Online Price War is Slashing Commission Prices*, BUS. WK., Dec. 8, 1997, at 112 (stating that online price wars may someday lead to investors being paid to trade).

[37] *See Trading Places: Readers Talk Back About Online Brokers*, BARRON'S, Apr. 13, 1998, at 52.

will ever completely disappear.

In terms of future trends, there will be a consolidation, as in all of our businesses. I think we can see that happening today. A number of the major discounters have been acquired over the past six months — Quick & Rielly by Fleet Bank approximately two months ago, and Jack White & Co. by Waterhouse Investor Services. This trend will continue and I suspect that there will be many survivors. That includes major players, and others who have figured out creative ways to do business.

Another result that may be inevitable is the discounters' movement into online banking.[38] Banks take a rather nonchalant, defensive attitude toward this, but some major discounters, like Schwab, Fidelity, and Microsoft, may be major players in this area. They will all move into online banking if they have not already. They are doing it today, even National Discount Brokers. Although most serious players in online brokerage have preferred checking accounts, there are a number that have already moved into the consumer loan area, including mortgages, car loans, etc.[39] Consequently, it seems inevitable that there is going to be a migration from brokerage into banking.

For the battled and hardened veterans of the online trading industry, banking appears to be a boundless source of highly profitable incremental revenue. Moreover, because some discounters have enormous customer bases, their strategy often becomes a question of trying to up-sell and cross-sell as many products as they possibly can. Thus, for these reasons, banking is clearly going to be the next major thrust for online brokerage.

The danger of encroaching on the banks and online discount brokerage is the reaction had

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[38] *See generally* Rebecca Buckman, *Internet Brokerage Firms Break into Banking*, WALL ST. J., July 2, 1998, at C1 (discussing recent move by Internet brokerage firms into the banking and financial services industries).

by major wire houses. Clearly, they have captured a significant market share, but as they now begin to venture into the banking industry, I think there is the risk that they will join forces with the chorus of detractors that exist today. Furthermore, as the discount brokerage business becomes an increasingly prevalent factor, they are going to have to deal with competitive responses from major wire houses and banks. Nonetheless, I think this is a battle to be fought in the regulatory arena, rather than in the competitive arena. Finally, I suspect there will be an increased focus on "knowing the customer", which becomes difficult when the people on the Internet may be anywhere in the world.

Another issue, which is related to the Internet's breadth, is a stronger observance of foreign securities laws. In theory, it might be suggested that a broker-dealer, doing business on the web anywhere in the world, should register in every country where it is capable of doing business. Although this matter is something that is being clarified even as we speak, it is doubtful whether any of the online brokerage firms register in this manner. Yet, from a regulatory perspective, this is something regulators cannot ignore.

The other matter that has been an issue is the quality of service across the bandwidth. CNBC reported that Charles Schwab suffered some downtime on their system due to extremely high trading volume.[40] In addition, last October many of the major discounters, as well as some wire houses had difficulty servicing the traffic.[41] Consequently, the ability to service customers reliably will be another hot button in the regulatory arena.

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[39] *See id.*

[40] *See* Mary Lord, *Online Trading Works, Shakily Busy Signal,* U.S. NEWS & WORLD REP., Nov. 10, 1997, at 32.

[41] *See id.* (noting that Charles Schwab & Co.'s online trading response time slowed at one point to 16 seconds).

ARTHUR PACHECO:[42]

I am here today to discuss Strike Technologies LLC ("Strike"). Strike is a new electronic limit order book that has been set up by software developers at Bear Stearns & Co. ("Bear Stearns") and its partners during the last year. It is one of the new ECNs that has been approved as a major trading tool for Nasdaq stocks.[43] Before I go into what exactly Strike does and what it will offer to its target audience of broker-dealers, market makers and institutions, I will begin with a discussion on the recent changes in the way that Bear Stearns is doing business.

Bear Stearns has been dedicated to providing clearing services for more than 23 years.[44] We service broker-dealers, hedge fund managers, short sellers, arbitrageurs and other professional investors trading at multiple securities firms.[45]

Recently, Bear Stearns decided to move into a non-traditional business with its launch of Strike. This decision was motivated by two different sets of factors. First, Bear Stearns faced external pressures from changes in the economics of its business. The cost of trading stocks had gone up and continued to do so. Bear Stearns was unable to impact the squeeze being made on its profit margins. We concluded that the only way to face our external pressures was to change our cost structure. To do this, Bear Stearns needed to make every effort to expand and custom-tailor its services to client needs while keeping costs to a minimum and spreading them over an increasingly large client base.[46]

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[42] President and Chief Executive Officer, Strike Technologies LLP.

[43] *See New ECN 'Strike' in Testing Phase*, SEC. WK., Feb. 16, 1998, at 3 [hereinafter *ECN 'Strike'*] (stating that Strike is the low cost alternative to Instinet which also serves as an electronic limit order book).

[44] *See* Gary Scott, *Maintaining a Competitive Edge as the Needs of the Investment Industry Change, Clearing and Execution Firms Must Adapt*, ON WALL ST., Feb. 1, 1998, *available in* 1998 WL 11649521 (describing and analyzing the competitive strategies of several clearing firms).

[45] *See id.*

[46] *See* Steve Quickel, *Keeping with the Market Boom*, INST. INV., Nov. 1, 1997, at SS3 (advising on how Bear Stearns could counter-act negative publicity).

NEW COMPETITORS

The rising cost of business today is due in part to the increased use of trading systems. These trading systems have begun to compete with broker-dealers for their core business, even though they do not have the same cost structure or obligations that the market makers do. Even our own SRO has made the decision to compete with us. The changes in regulation and market structure have required us to adapt and to respond to these initiatives with innovative technology.

The second factor included a change in the landscape in securities markets. We recognized that changes in technology and communication have made new types of markets and new ways of trading a possibility. We have not stopped believing in the merits of the established auction and dealer marketplaces and their importance individually to the capital formation structure. Bear Stearns believes in these systems and supports their unique contributions to the capital market structure. However, we have accepted the reality that markets change. The evolution of securities markets in this country, particularly the equity markets, has been monumental in scope. The possibilities emerging from the marriage of communication and technology will certainly drive the next stage of development for our markets.

As professionals, we must be sensitive to our customers' needs. In this industry, we recognize that some of our more sophisticated customers expect us to provide them with information, services, and delivery systems that today's new technologies make possible. Our dealers must have comparable abilities in order to compete in the global markets.

We have chosen to respond to these catalysts for change by launching Strike. Strike is a new entrant into the alternative trading system market place. It will offer an electronic medium through which broker-dealers, market makers and institutions can trade by referencing the central repository of orders and indications.

Our goal, with the launch of Strike, is to provide a tool for broker-dealers to fill their

obligations in the handling of customer orders, as well as to provide a low-cost mechanism for the dispersion of risk and liquidity of positions. We also want to furnish our customers with a fast, cost-efficient and anonymous medium to access liquidity.

Currently, we are exploring potential linkages to other ECNs and to other marketplaces in order to provide our customers with flexibility and ease of access in the execution of their orders. In addition, we have no institutional sales force, which will keep us from competing with our constituency.

Strike has been set up as a limited liability firm that is backed by eighteen different investors that includes a consortium of some of Wall Street's biggest players.[47] While Strike will be an independent entity, its corporate structure contains a consortium of OTC dealers and high tech firms as well as certain strategic relationships. Bear Stearns has three major partners in Strike: Salomon Smith Barney; Herzog, Heine Geduld, Inc. ("Herzog"); and Bridge Trading Co.[48] Other securities firms include Donaldson, Lufkin & Jenrette Securities Corp.; First Southwest; Hambrecht & Quist, ING Barings Furman Selz; J.W. Charles; John G. Kinnard, Nationsbank Montgomery Securities, Inc.; PaineWebber; Susquehanna Corp; Cantor Fitzgerald; and Nikko Securities.[49] Also included are the technological firms of Sun Microsystems and Neovison Hypersystems.[50]

We expect that with this collection of owner-participants and their respective sales forces, in addition to its built-in trading volume and relatively cheap pricing, Strike will generate the

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[47] *See* Sarah Stirland, *Automated Trading & Straight-Through Processing: Brokerage Heavyweights Take a Swing at ECNs with Strike*, SEC. INDUS. NEWS, Aug. 31, 1998, at 5.

[48] *See* Heike Wipperfurth, *New Industry-Backed ECN Hopes to Challenge Instinet's Dominance; Bear Stearns and its Team of OTC Partners Bring in Built-in Volume*, INV. DEALERS' DIG., Aug. 24, 1998, at 24 [hereinafter *Industry-Backed ECN*].

[49] *See id.*

[50] *See id.*

critical mass it needs to make it a viable competitor in the ECN marketplace.[51] Further factors that should contribute to Strike's ultimate success include access to the vast distribution capabilities of Bridge Information Systems, Inc. ("Bridge"). Bridge will use its network to provide users with real-time information on global financial markets and deliver this information to their browsers via the Internet. Other factors include Knight-Ridder's approximately 60,000 terminals, the 2,400 firms in Bear Stearns and Herzog's clearing and correspondent networks, and the enthusiastic response that Strike has received from the institutional community.

Strike's technology has been developed for broker-dealers, market makers and institutions on both the buy and the sell sides of a transaction. The firms that will execute orders on Strike will be able to access Strike's limit order book in one of two ways. They may either connect to a secure proprietary network developed by Bear Stearns or through a network and front-end application provided by Bridge. Those using Nasdaq's SelectNet will also be able to access the system. The desirable result of this accessibility is a technologically advanced and effective system that is user-friendly and event-driven.

Strike offers its customers an open system that is accessible via a JAVA enabled web browser. This open system has either order entry screens on Bridge terminals or a Fix-based application programming interface ("API") that allows the user to interface the trade blotter and back office operating at Strike.[52] Because it is an open system written in Sun Microsystem's JAVA language, traders do not have to add yet another box to their crowded desks when they sign up. In the incipient stages, Strike will run over heavy-duty phone lines. In the future it can be accessed via the World Wide Web.[53] The system further encompasses links to POSIT, the

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[51] *See id.* (describing Strike's competitive advantages over the other ECNs).
[52] *See ECN 'Strike', supra* note 43 (describing how Strike will be made available to its users).
[53] *See Industry-Backed ECN, supra* note 48 (noting plans for Strike's future availability).

trade matching system, and the AZX.[54]

Our ultimate goal is to achieve general Internet connectivity, because we recognize the increasing interest from the trading and investment communities in the Internet. In the future, we foresee an investor or trader in Jakarta or Montevideo, or anywhere in the world, being able to trade any security anonymously and securely at any time. One would only need a laptop, an access code, a Web Browser, and a credit balance. While this might not seem attainable in the near future, the probability for this to occur may not be too far away.

Hopefully, this has given you some idea of what we are doing and what our plans are for Strike.

[54] *See id.* (discussing Strike's strategy to funnel additional order flow).