



A PRIMER ON SECURITIES MARKET STRUCTURE

Q. What is market structure?

A: “Market structure” is a broad term that refers to the way individual securities markets are organized to execute orders (e.g., a competing dealer market such as NASDAQ, versus an auction market such as the NYSE). This term also refers to the manner in which these markets must interact with each other when they are trading the same security. To protect investors, every country that has a stock market (or markets) regulates the listing, selling, and buying of shares in publicly traded companies and monitors the trading practices of investors, brokers, dealers, and exchanges. The regulatory and enforcement authority that oversees the stock markets in the United States is the Securities and Exchange Commission (SEC).

The SEC is now considering changes in market structure to enhance and modernize the existing national market system (NMS) rules adopted under Section 11A of the Securities Exchange Act of 1934. This primer provides background on the major issues addressed by the SEC’s proposed Regulation NMS.

Q. Who are the key players in the U.S. securities markets?

A: The two largest primary stock markets in the U.S. are the NASDAQ Stock Market (which accounts for more than 56% of total share volume and trades the most stocks of any market) and the New York Stock Exchange (NYSE, with about 37% of the total volume and roughly 2,800 listed companies). Much smaller markets include the American Stock Exchange (Amex, which is more active in options and exchange-traded funds than in equities) and five regional exchanges: Chicago, Boston, National (formerly Cincinnati) Philadelphia, and Pacific.

Investors may trade stocks in different markets, regardless of where the stock is officially listed. Thus, one can trade a NYSE-listed stock not only on the NYSE but also through the NASDAQ or the regional exchanges. However, the NYSE and Amex have chosen to trade very few stocks that do not officially list on their own exchanges.

Q: What are the differences between NASDAQ and the NYSE?

A: NASDAQ is a fully computerized market capable of linking all liquidity providers in a given stock together, so they can compete with each other quickly, efficiently, and on an equal footing. NASDAQ's basic philosophy is one of "open architecture": market participation is not limited, and any firm that meets the basic requirements can join. The flexibility of this network means that a large number of players with very different business models and trading technologies can participate. It also means that innovators with new technologies or strategies can implement them quickly.

NASDAQ participants include about 300 market makers who commit capital and buy inventory to sell to their customers (i.e., investors). The average NASDAQ stock has at least 15 market makers, who are required at all times to post their bid and ask prices into the NASDAQ network, where they can be viewed and accessed by all participants. In addition to market makers, NASDAQ also connects alternative trading systems/electronic communication networks, which electronically match buy and sell orders submitted to them. Unlike market makers, who are required to buy and sell at all times, alternative trading systems/electronic communications networks only execute trades when matching buy and sell orders have been submitted to them.

On the NYSE, all orders flow to a single specialist for each stock, who works on the trading floor in New York. The specialist is obliged to maintain a "fair and orderly market" for a particular stock and act as both sole market maker (posting bid and ask quotes all the time) and auctioneer (trying to match orders of other customers sent to the NYSE floor). For larger orders, floor brokers may negotiate face-to-face on behalf of their customers, trading with the specialist or other floor brokers interested in the same stock. Smaller orders are usually routed electronically to the specialist's order book.

Access to the NYSE floor is limited to 1,366 members, who collectively own the exchange. To become a member, one has to purchase (or lease) a membership, called a "seat," from another member who wants to sell. Memberships cost in the neighborhood of \$1.5 million.

Q: Why is there a need for market structure reform?

A: There are three broad factors driving the need for market structure reform:

1. The need to promote greater interaction and displayed depth of investor orders, particularly for the very large orders of institutional investors;
2. The need to create a level playing field, with uniform regulation of and free competition among all types of market centers, and
3. The need to update rules that were written long before anyone envisioned the technologies we have today.

Much of today's market structure is premised on an understanding of markets as they existed prior to the introduction of computerized trading systems, which compete with or supplement dealer markets and traditional exchanges. These private systems do not provide listing services, but they do facilitate electronic trading in millions of shares of public issues every day.

Not so long ago, the national market system could be divided fairly clearly between the traditional auction markets (NYSE, Amex, etc.), which dominated trading in their own listed stocks, and the market makers, who dominated trading in NASDAQ stocks. Today, these divisions are disappearing as automated order-matching systems capture an increasing proportion of share volume.

Electronic communications networks (ECNs), one important type of alternative trading system, match customer buy and sell orders directly through a computer. ECNs act on behalf of customers and do not commit their own capital to securities. ECNs accept orders directly from their own subscribers in addition to customer orders routed from other brokerage firms.

Q: What is NASDAQ's perspective on market structure reform?

A: NASDAQ believes that market structure reform is critical to promoting free choice for investors, enabling fair and open competition among market participants, and ensuring the competitiveness of U.S. capital markets. U.S. stock markets and exchanges are "self-regulatory organizations" (SROs).

Q: NASDAQ's perspective on market structure reform (Cont'd)

In NASDAQ's view, reforming the rules that govern these SROs requires a system that is flexible, reflective of the changes ushered in by technology, and, most importantly, transparent, strengthening the confidence of American investors in these institutions.

More specifically, NASDAQ supports market structure reforms that will:

1. Ensure best execution for investors, recognizing that different investors have different trading needs and that "best price" is only one element of best execution. Other relevant factors for determining what constitutes "best execution" include liquidity and the cost and difficulty of obtaining an execution at particular market.
2. Create even more robust competition than we have today
3. Aggressively leverage technology to make markets more transparent and open to all participants

One of the core debates on market structure focuses on the optimal degree of coordination among today's multiple, competing market centers. Some have suggested increasing order interaction by moving towards a "central limit order book" (commonly referred to as a "CLOB") – a single market center through which all trading activity must flow. The trade-off of a CLOB would be decreased competition among market centers, i.e., less incentive to innovate and lower transaction costs.

Q: What changes are under consideration by the Securities and Exchange Commission?

A: The SEC's Regulation NMS – now out for public comment through May 24– proposes four broad regulatory changes designed to enhance and modernize the national market system (NMS) rules:

First, and most important, the Commission is proposing a uniform trade-through rule for all NMS market centers that reaffirms the importance of trading at the best price displayed by any market, but that also recognizes

the importance of determining best price by factoring in speed of execution, liquidity, and other factors.

Q: Changes are under consideration by the Securities and Exchange Commission (Cont'd)

For example, the proposal allows certain important exceptions that address problems posed by the inherent difference in the nature of prices displayed by automated markets such as NASDAQ, which are immediately accessible to all participants, versus those displayed by manual markets such as the NYSE, where a human being (i.e., the specialists) matches orders and may take advantage of price information that is not available to others.

Second, the Commission is proposing a market access rule that would modernize the terms of access to quotations and execution of orders in the NMS. This change would help assure nondiscriminatory access to the best prices displayed by NMS market centers, but without mandating inflexible, "hard" linkages such as the Intermarket Trading System (ITS), the computer network that links NASDAQ, the NYSE, the smaller regional exchanges.

The third proposal would prohibit market participants from accepting, ranking, or displaying orders, quotes, or indications of interest in a pricing increment finer than a penny, except for securities with a share price of less than \$1.00. This change should promote greater price transparency and consistency across markets.

Finally, the SEC is proposing amendments to the rules for disseminating market information to the public that, among other things, would reward SROs for more broadly based contributions to public price discovery. For more information on Reg NMS:

<http://www.sec.gov/rules/proposed/34-49325.pdf>

NASDAQ Testimony Filed with the SEC:

<http://www.NasdaqNews.com>

NASDAQ Statement Regarding Reg NMS February 24, 2004

http://www.nasdaqnews.com/news/pr2004/ne_section04_020.html