

# **Country Funds and Global ETF Conference**

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## ***Specialist's Roles in Trading ETFs***

*Daniel S. Curran*

*Member*

*Turning Point Securities, L.L.C.*

# How are stocks assigned by an exchange?

The assignment is to the specialist firm,  
not the individual co-specialist.

Factors considered:

- Amount of capital
- Number of co-specialists
- Number of assigned stocks
- Quality of markets
- Co-specialist evaluation questionnaire
- Actions against specialist firm
- Actions against co-specialist
- Recent stock assignments
- Price improvement
- Requests by issuer of stock
- Market share

# Where can ETF orders be directed?

- Exchanges
  - American
  - Chicago
  - Boston
  - Cincinnati
  - New York
- Third Market Firms
  - Knight-Trimark
  - Madoff
  - Other
- ECNs
  - Island
  - Archipelago
  - Other

# Where should ETF orders be directed?

- Quality of execution
- Customer service
- Payment for order flow

# How is quality of execution measured?

By type of order

- Markets
- Marketable limits
- Limits

By type of stock

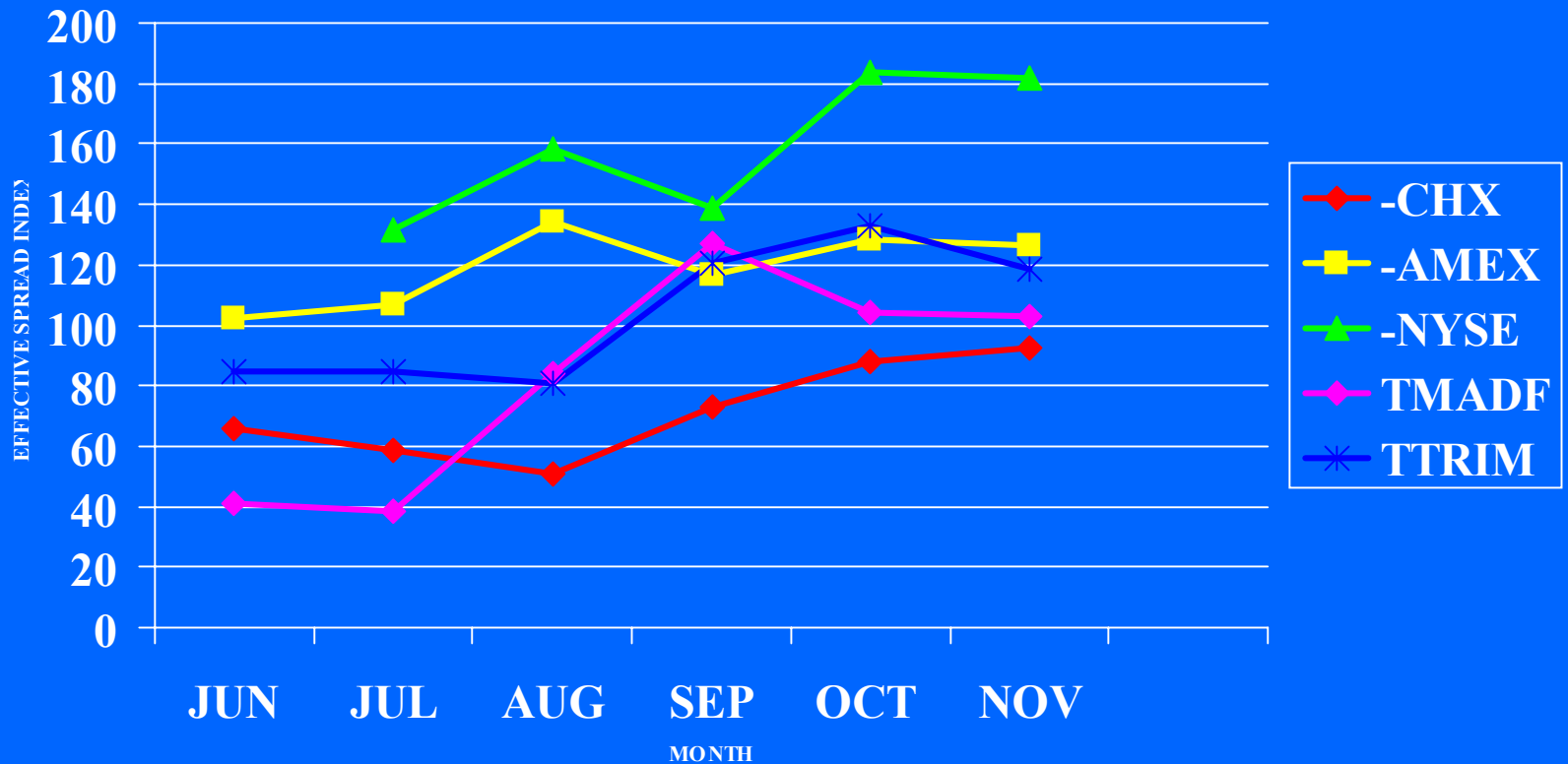
- By exchange
- By order sender
- By stock

# What are measures of quality?

- Effective spread
- Trades within NBBO (number and price)
- Trades outside NBBO (number and price)
- Net price improvement (combine all trades)
- Liquidity premium (filling greater than NBBO)
- Speed of execution
- Procedures when exchange has an outage
- Other
  - Handling of partials
  - Pre-opening orders
  - Limit order display
  - Auto-execution levels
  - Price improvement algorithm

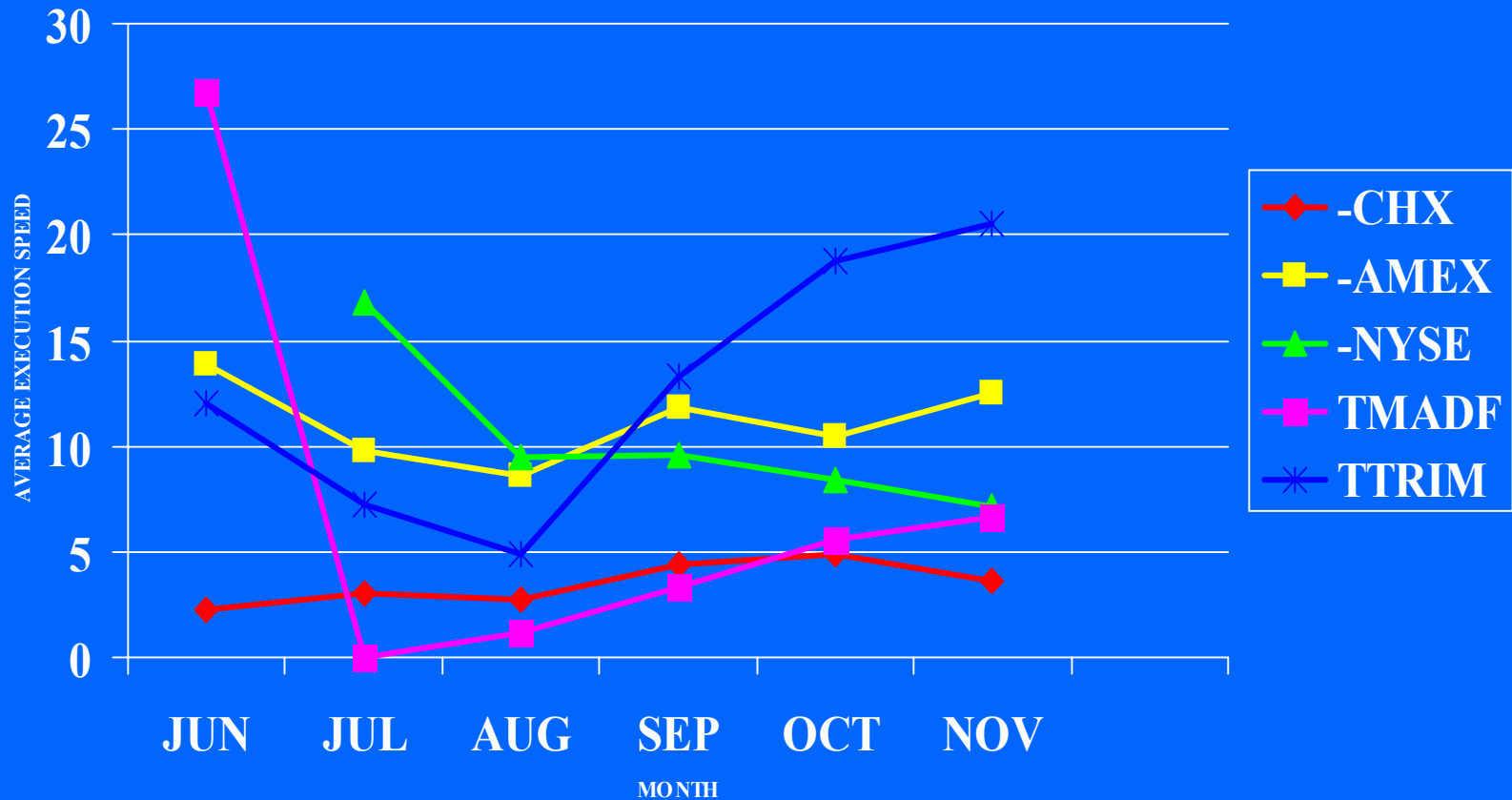
# A: EFFECTIVE SPREAD INDEX

100-1999 Order Size, Market Orders



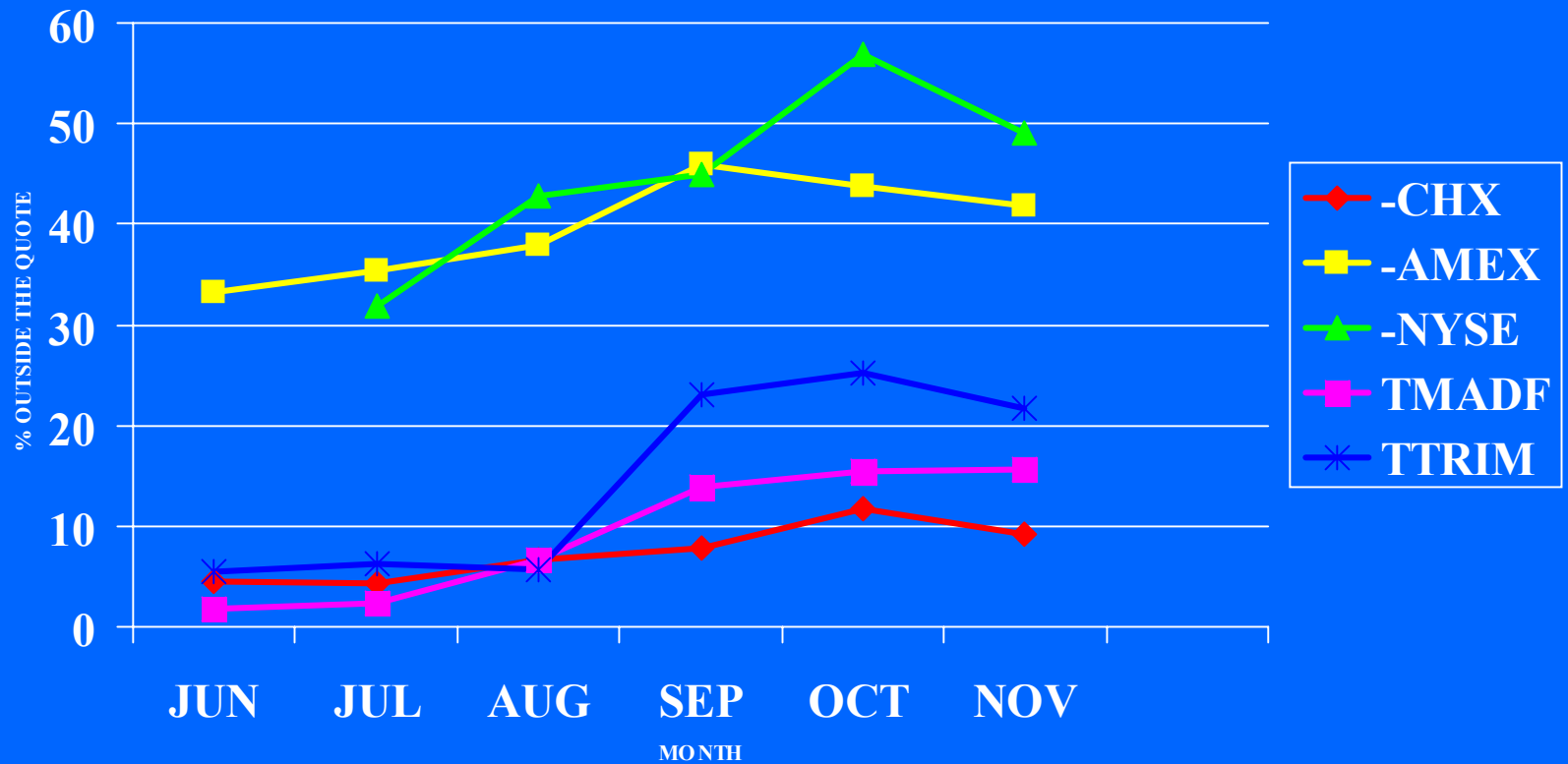
# B: AVERAGE EXECUTION SPEED

100-1999 Order Size, Market Orders



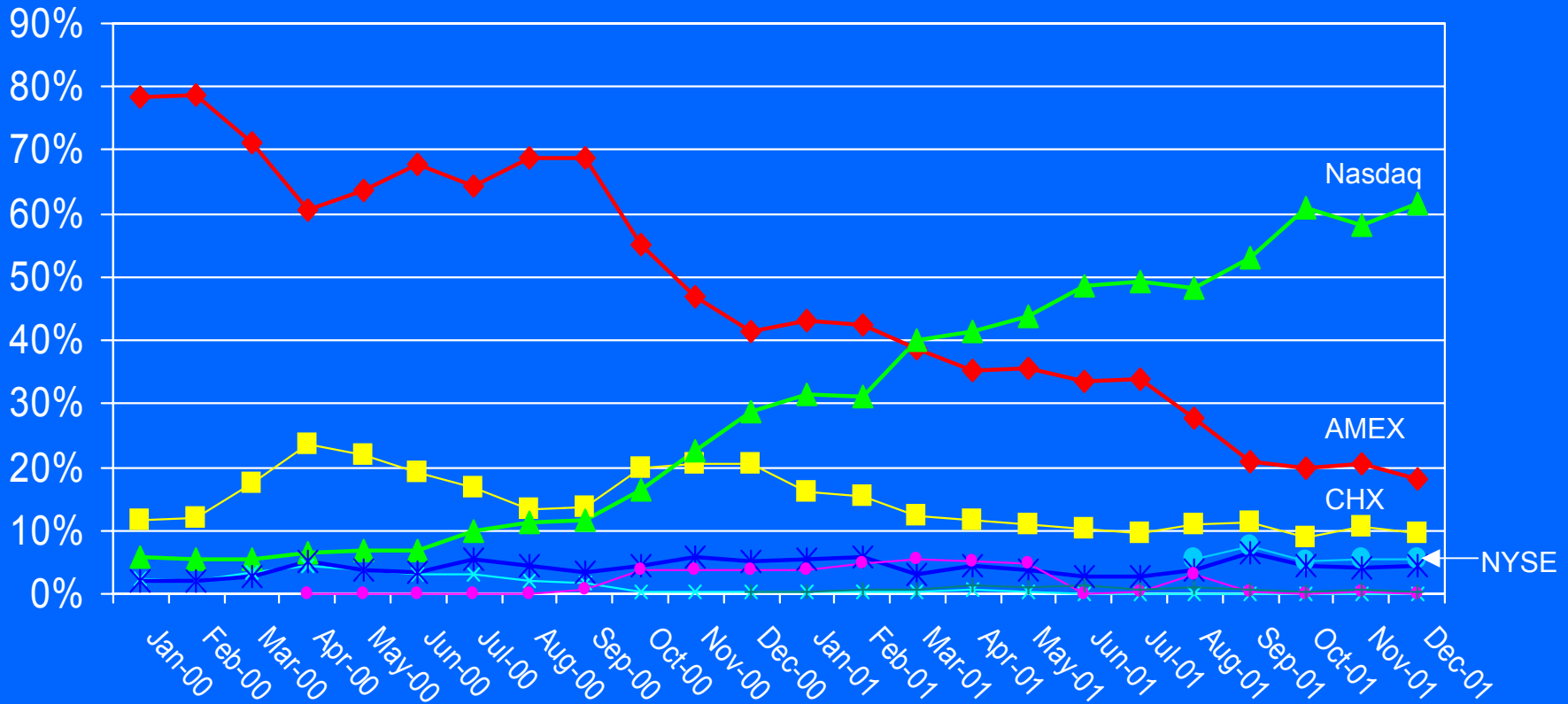
# C: PERCENT OUTSIDE THE QUOTE

100-1999 Order Size, Market Orders



**Where are ETFs traded?**

# QQQ Trade Share

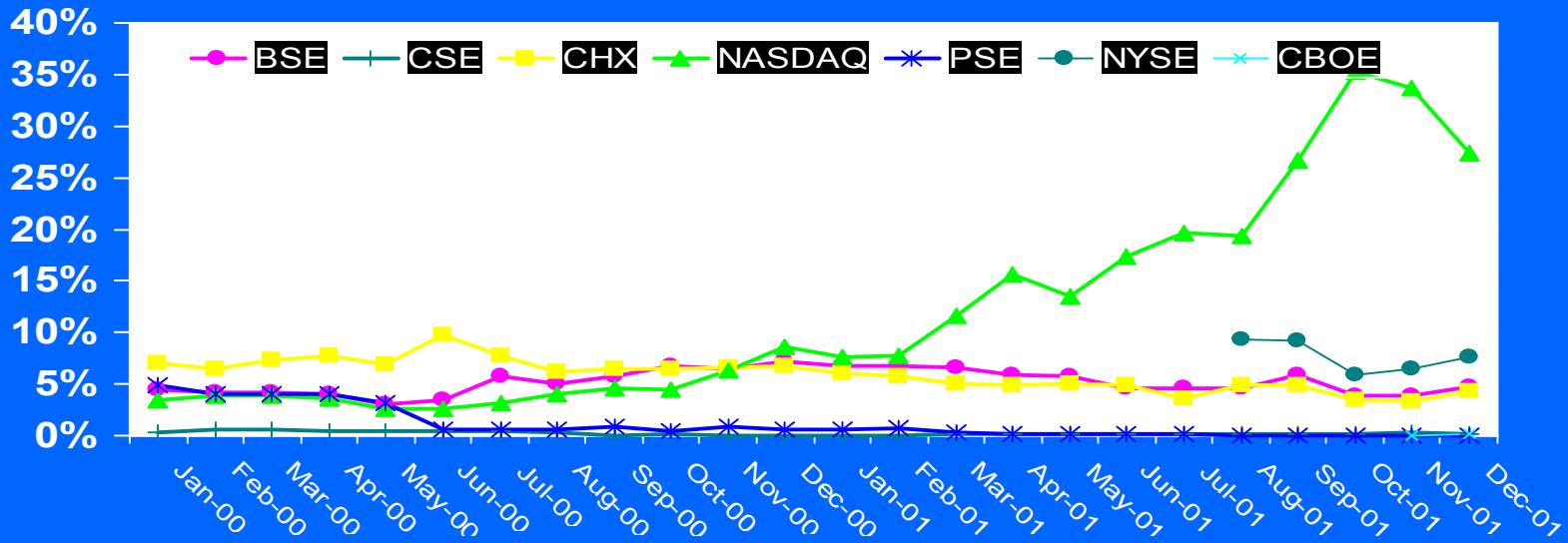
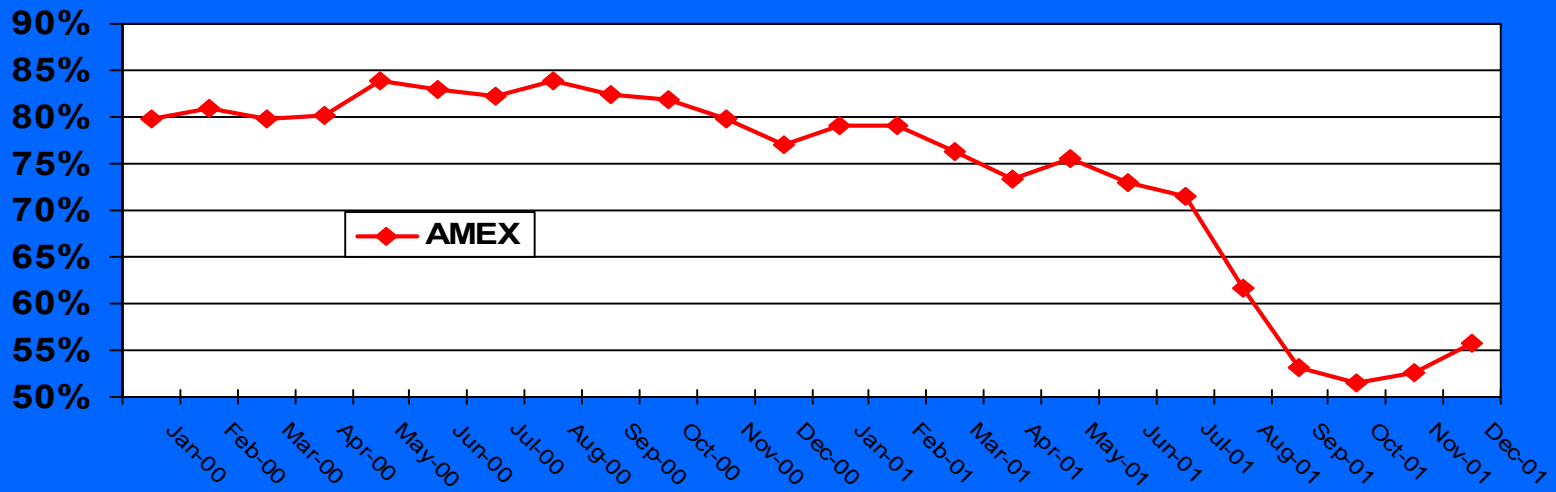


# Nasdaq QQQ Volume Market Share

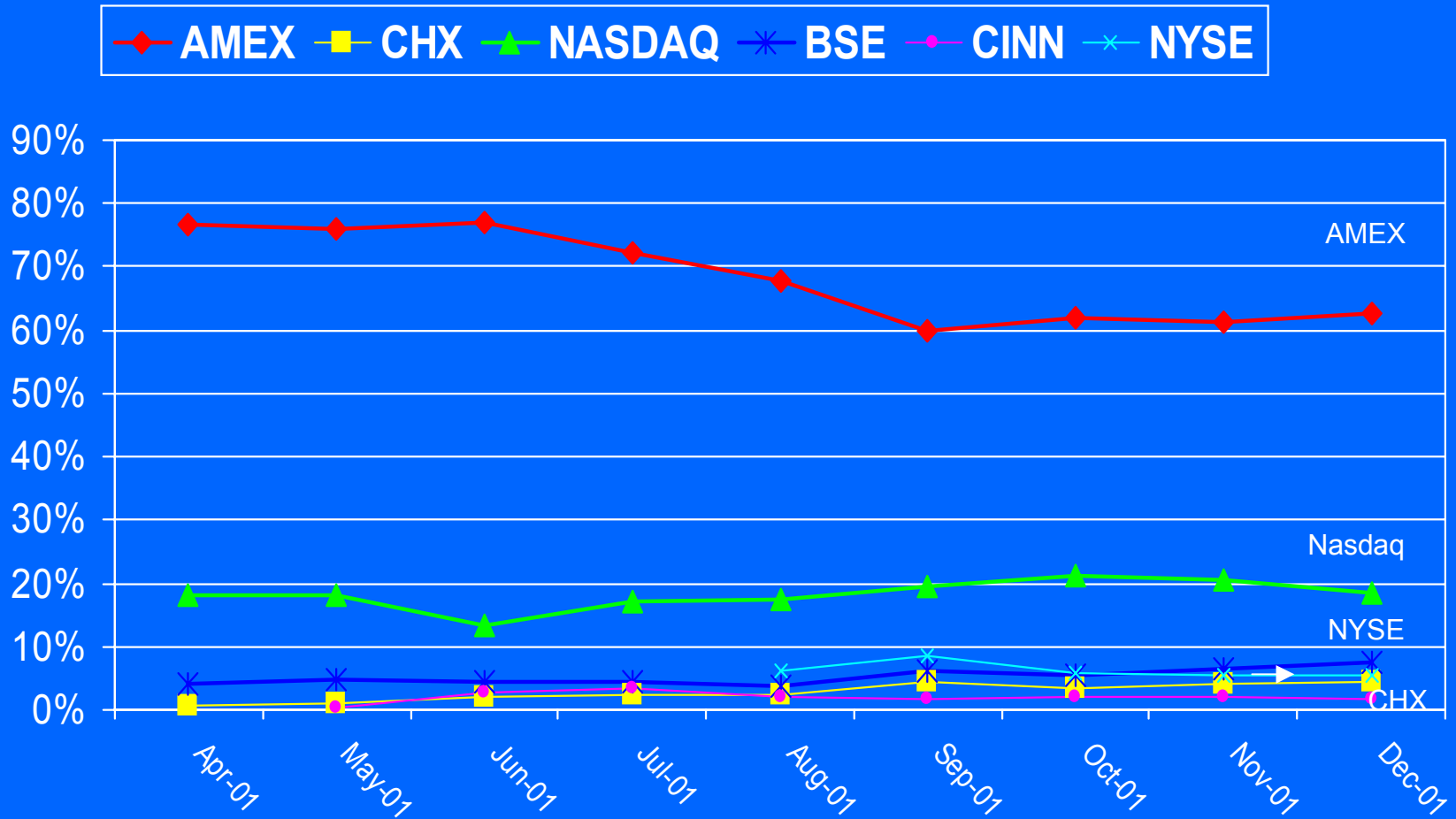
	Nasdaq Ex-ISLD	ISLD
4Q 00	14.85%	2.95%
1Q 01	16.51%	7.94%
2Q 01	22.06%	14.68%
3Q 01	23.86%	18.77%
4Q 01*	26.16%	22.88%

\*Run rate utilizing ISLD data through 10-17-01

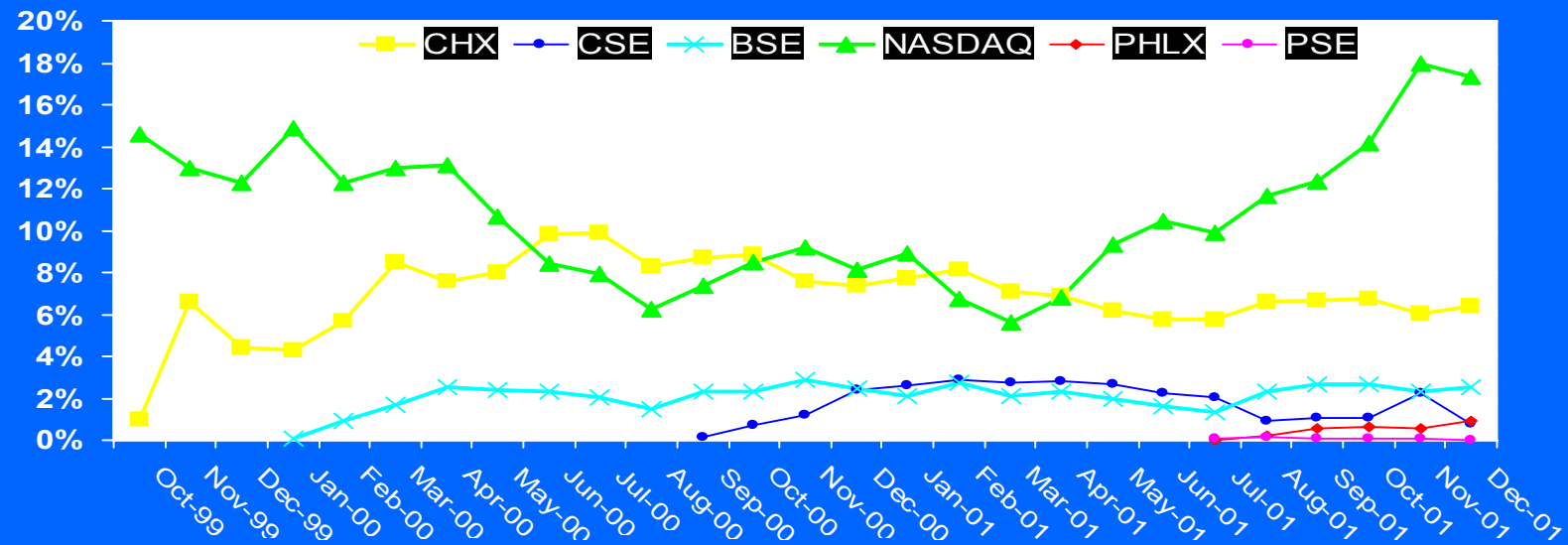
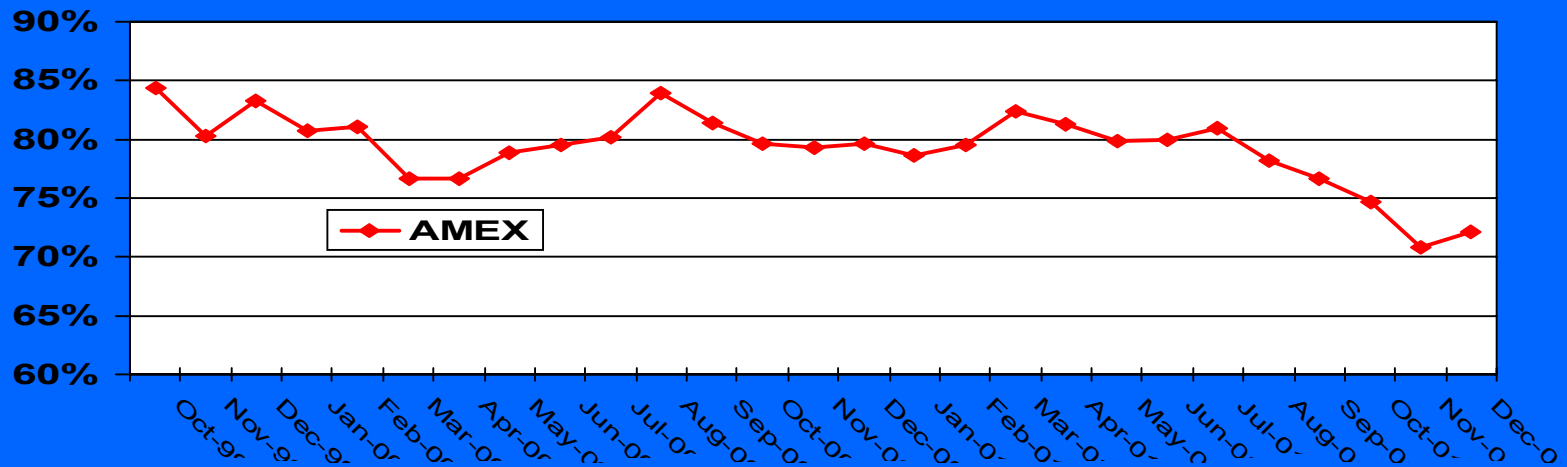
# SPDR Trade Market Share



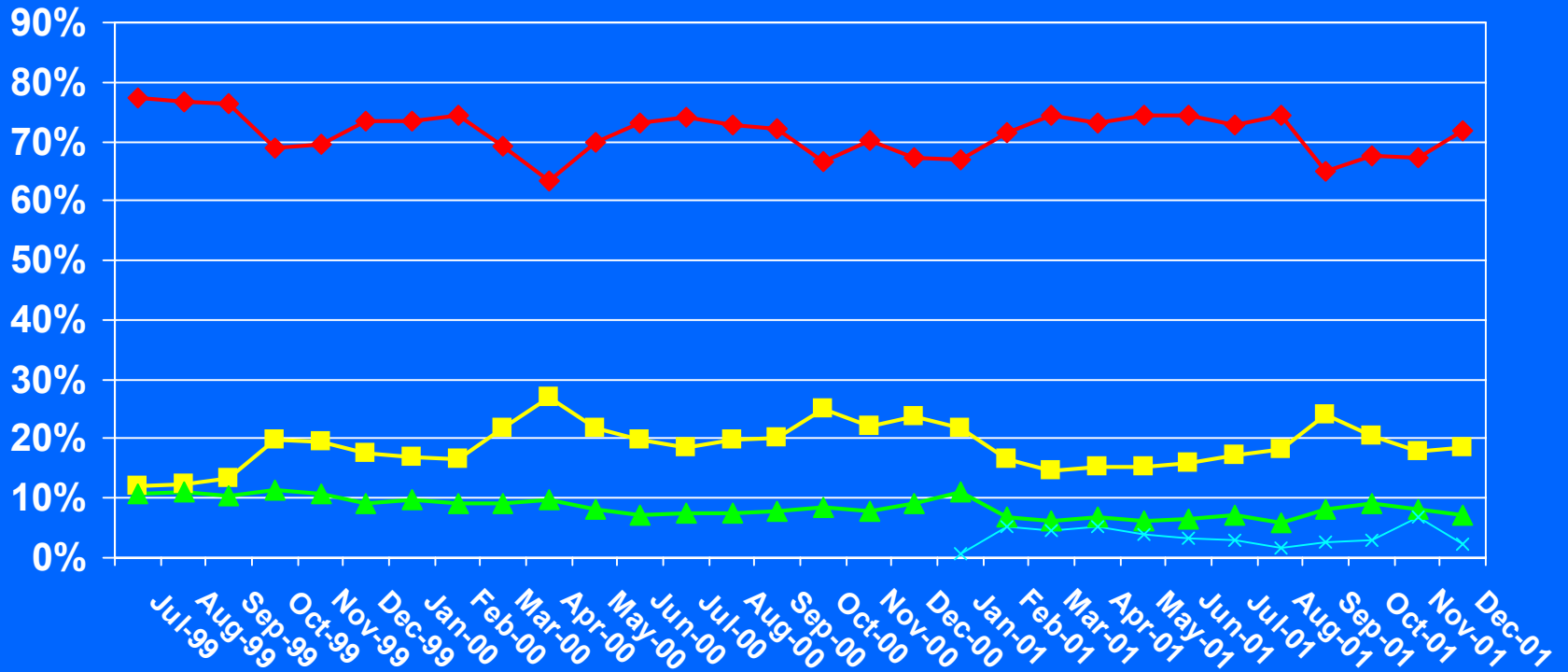
# Diamond Trade Market Share



# HOLDERS Trade Market Share



# Sector SPDR Trade Share



# Profile of the Chicago Stock Exchange

- Trades over 4,500 stocks (listed, OTC, ETFs [trade all stocks underlying ETFs])
- Excess capacity (doing 600,000 trades/day, capacity 2,000,000 trades/day)
- Low cost
  - No fees on AMEX stocks
  - No fees on market orders
  - No specialist fees
  - Block trade maximum fee \$100 per side
  - No fees on S&P 500 stocks
  - No fees on limit orders < 599 shares
  - Quantity discounts
- Payment for order flow

# How does the specialist make money?

- Trade the spread
- Take a position
- Use limit orders in the book
- Arbitrage vs. mispricing of similar securities

# How are retail orders handled?

- Fully automated with ability to route, execute and report in less than one second
- Internet-based system – 70% of all CHX trades are internet-based (11 of 12 top internet firms do business with the CHX)
- Best rule guarantees NBBO or better and may be price improved
- Liquidity enhancement algorithm
- Limit order display requirement
- Limit order reconciliation

# How are institutional orders handled?

- Largest floor broker population outside New York—most major firms use independent floor brokers
- Have Brokerplex system
  - Electronic entry to post
  - Electronic report to floor broker
  - Automated basket systems
  - VWAP systems
- Limit order display rules
- Best execution rule—customer orders have precedence

# How are Nasdaq stocks handled?

- All ETF index stocks trade on the CHX
- Uses the CHX MAX system
- Agency order has precedence
- Auto-execution
- Price improvement

# How is the ETF quote computed?

- Direct line feed from the Merc for futures prices
- Direct line feed from SIAC for underlying stock prices
- Proprietary computer-derived formula computes SPY value at any point in time
- The quote is then created considering existing position, spread relationships, volatility, etc.
- Employee and voice communications to the Merc
- Options input from the CBOE

# How are ETF orders hedged?

- Vs. basket of stocks
  - Full basket
  - Partial basket
- By creation and/or redemption
- Vs. futures
  - Liquidity of ETF greater with futures contracts
  - S&P 500 roll has been expensive—costs are higher than Libor
  - Can use EFP to shift from future to basket
  - Must consider time horizon
  - Calendar spread gives implied rate

- Vs. options
  - Alters risk reward parameters
  - Consider skew
    - » Maturity of options
    - » In vs. out of money options
- Vs. existing positions
- Rebalancing
  - New economy creates and destroys
  - Effect on benchmarks
  - Effected by IPOs
- Work with
  - Upstairs – order sending firms
  - Market makers
  - Floor brokers

# Conclusion

- Retail and professional ETF orders should be directed for quality execution
- There are many measures of quality
- All basket stocks from ETFs trade on CHX
- The values and quotes are from proprietary formulas
- The specialist works to create a liquid market, hedging the ETF, and working with order senders, market makers and institutional firms
- ECNs are increasing their market share