

History lesson on the evolution of exchanges

Market delays and intervention of market makers created a demand for a faster and specialist free exchange.

This led to the birth of Instinet, the first Electronic communication network (ECN). Instinet was founded by Jerome M. Pustilnik and Herbert R. Behrens and was incorporated in 1967 as Institutional Networks Corp.

The founders aimed to compete with the New York Stock Exchange by means of computer links between major institutions, such as banks, mutual funds, and insurance companies.

Then Black Monday happened.



During the crash of 1987, electronic trading systems allowed trading when brokers and market makers were unwilling to answer their phones during the free-fall.

Market Maker collusion was the last straw for regulation change.

In 1994, a study by two economists showed possible Market Maker Bid/Ask Spread price collusion resulted in an anti-trust lawsuit against NASDAQ. As part of NASDAQ's settlement of the antitrust charges, NASDAQ adopted new order handling rules that integrated ECNs into the NASDAQ system.

Shortly after this settlement, the SEC adopted Regulation ATS, which permitted ECNs the option of registering as stock exchanges.

ECN (Electronic Communication Network)

This is an electronic system that accepts/dessiminates orders entered into it and permits the orders to be executed against.

As ECNs were permitted to act as exchanges, Instinet and Island exploded in popularity. Archipelago (ARCA) Exchange was born and new ECNs emerged.

Archipelago (ARCA) exchange

Founded in 1994 by Stuart Townsend and Gerald Putman.

First orders accepted on January 20, 1997.

Brand new pricing scheme that changed everything.

The new pricing scheme went as follow:

- Rebate for adding liquidity

- Fee for removing liquidity

Example: ARCA: add \$0.002, remove -\$0.003

Incentive for people to Add liquidity on ECNs instead of on the actual exchange.

Incentive for people to remove liquidity (even though more expensive) on ECNs because there is more liquidity there.

If you can't beat them. Buy them.

Instinet in 2002 merged with the Island ECN, renaming the Island technology platform Inet.

In 2005 NASDAQ buys Inet

In 2006 NYSE buys Arca

Sample Fee Structure of current ECNs

ECN	Add	Remove
NSDQBX	\$0.0025	\$0
EDGA	\$0.0005	\$(0.0002)
EDGX	\$ (0.0020)	\$0.0029
NYSE	(\$0.0013)	\$0.0031
ARCA	(\$0.0020)	\$0.0030
BYX	\$0.0018	(\$0.0015)
BATS	(\$0.0020)	\$0.0030

Level 2 example



CITIGROUP INC [C] - (7) - Level II

Actions View

C 0.430 59.421 60.320

300 P SHRT SELL BUY

Ord qty (Default)

ECN	Price	Qty	ECN	Price	Qty
NYSE	59.660	1100	NYSE	59.670	900
ARCA	59.660	600	BATS	59.670	300
NASD	59.660	500	ARCA	59.670	300
EDGX	59.660	400	EDGX	59.670	300
BATS	59.660	200	NASD	59.670	200
EDGA	59.660	100	BYX	59.670	100
BYX	59.650	100	EDGA	59.690	100
NQPX	59.630	500	NQBX	59.690	100
NQBX	59.620	200	NQPX	59.710	1500
EAB	59.620	100	EAB	59.720	200
EAB	58.780	30	EAB	60.600	100
EAB	57.040	200	CHX	60.790	75000
EAB	56.580	100	EAB	61.500	100

N Flat



iShares Russell 2000 ETF [IWM] - (17) - Level II

Actions View

IWM 1.200 135.650 136.970

300 P SHRT SELL BUY

Ord qty (Default)

ECN	Price	Qty	ECN	Price	Qty
CHX	136.470	1000	ARCA	136.480	200
EDGX	136.470	600	NASD	136.480	200
ARCA	136.470	500	BATS	136.480	100
NASD	136.470	500	EDGX	136.480	100
BATS	136.470	300	CHX	136.490	1500
IEXG	136.470	100	EDGA	136.490	300
BYX	136.460	1800	BYX	136.490	300
EDGA	136.460	1600	NQBX	136.490	200
NQBX	136.460	1500	NSX	136.490	100
NSX	136.460	1000	NQPX	136.490	100
NQPX	136.460	500	IEXG	136.490	100
EAB	136.450	300	EAB	136.500	100
EAB	136.440	400	EAB	136.510	400
EAB	136.430	400	EAB	136.520	300
EAB	136.420	500	EAB	136.530	100
EAB	136.410	700	EAB	136.540	200
EAB	136.400	600	EAB	136.560	100
EAB	136.390	400	EAB	136.690	100

P Flat