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STUDY SHOWS I.T.S. MARKET MAKERS "REACH THROUGH" TO GET BETTER PRICES

Market makers throughout the country are using the experimental Intermarket Trading System (ITS) to "reach through" disseminated quotations in order to obtain better prices on trades, according to a SEC staff study made public today.

The study indicates that more than one-third of the reach-through attempts are successful in securing prices better than those reflected in current quotes. These successful reach-throughs account for over 10 percent of all ITS executions. Moreover, perhaps as much as one-fifth of all orders sent through the ITS represent an attempt to secure a better price than that being quoted at the time.

The ITS, which began operation in April 1978, is intended by its sponsors to be a component of the national market system called for by Congress in 1975 legislation. It consists of an automated communication system linking competing market makers on the American, Boston, Cincinnati, Midwest, New York, Pacific and Philadelphia stock exchanges. The monitoring report issued today, prepared by the Directorate of Economic and Policy Analysis, is the first such report issued by the Commission pursuant to its announced intention to monitor development of the ITS and other national market system initiatives. The report examines the growth and operation

of the ITS through November 1980. (During most of the study period, there were six exchanges participating in the ITS. Cincinnati was not linked with the system until February 1981).

The report says that information analyzed during the study, "suggests that the ITS serves as a vehicle for ferreting out trading interests which are not reflected in the existing quotes." It concludes that, "the ITS communications link is being utilized, to a considerable extent, to reach through the ITS in an attempt to obtain a price better than the published quote."

The study found that in each of four separate sample weeks, between 57 percent and 74 percent of all "cancellations" -- trades that were initiated but not completed -- involved unsuccessful reach-throughs. During the same weeks, more than 10 percent of ITS trades actually executed were identified as successful reach-throughs. A reach-through occurs when a market maker or broker on one exchange offers, through the ITS system, to execute a trade with a market maker or broker on another exchange at a price more favorable to himself than the one the other market maker is currently "publishing" (disseminating) through the consolidated quotation system.

The report says that as of November 1980 there were 871 stocks being traded through the ITS, compared to 273 in November 1978, the first year of the system's operation. On an average trading day in November 1980 there were 4.2 trades per stock executed through the ITS.

The study also found that market makers were using the ITS proportionately more often. In November 1980, ITS trading accounted

for 4.2 percent of all the shares traded in stocks that were included in the system and 6.6 percent of the number of trades in such stocks. Two years earlier, ITS had accounted for 3.7 percent of the composite share volume in those stocks and 4.7 percent of the total number of trades. Thus, one measure of the system's usage -- number of trades executed through ITS as compared to all trades executed in those stocks -- increased by some 40 percent over two years.

The study also examined the question of which exchanges were the most frequent participants in the ITS. It found that the New York Stock Exchange took part, either as the originating or executing (receiving) market center, in more than 90 percent of all ITS trades. Specifically, the NYSE executed about 60 percent of all the trades concluded through the ITS, and originated about 33 percent.

Another area examined was the phenomenon of "trade-throughs" which occur when an execution takes place in one ITS market center at a price inferior to the price then being offered by another ITS market center. Less than 1 percent of the trades involving ITS stocks were identified as trade-throughs in each of four sample weeks.

The study also probed the question of whether the ITS has resulted in a reduction in the "spread" between bid and asked prices for stocks traded in the system, but it found no significant effects. "(I)t cannot be concluded," the report states, "that the ITS caused the spreads in the primary market either to narrow or widen."

Copies of the "Monitoring Report on Operation of the Intermarket Trading System" may be obtained from the Office of Consumer Affairs and Information Services, U.S. Securities and Exchange Commission, Washington, D.C. 20549. Comments on the report are invited and should be directed to Jeffry L. Davis, Acting Director, Directorate of Economic and Policy Analysis, at the same address.

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