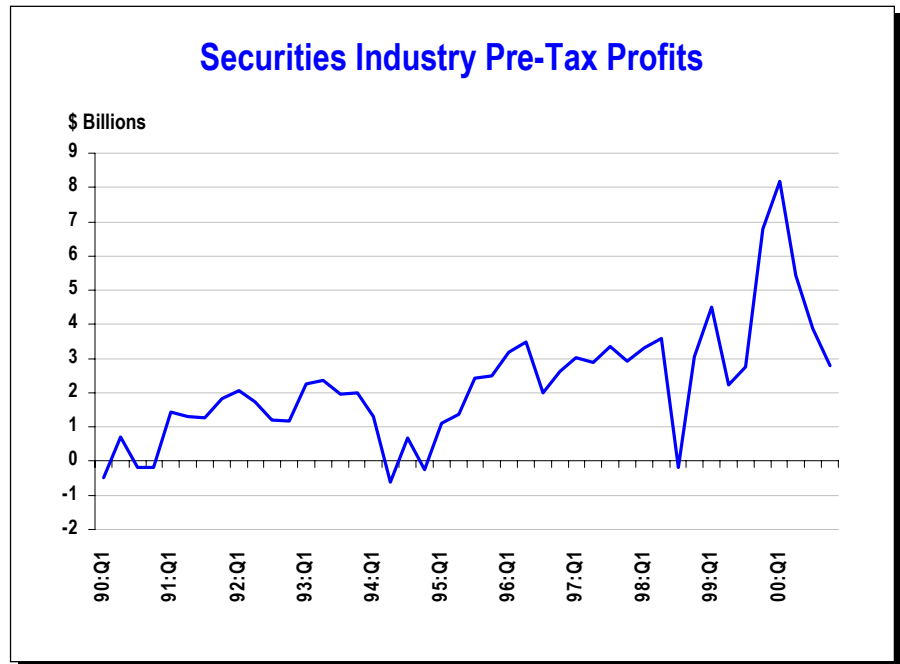


SECURITIES INDUSTRY OUTLOOK BRIGHTENS IN 1Q 2001

The pattern of sequential quarterly declines in industry revenues and profitability, which followed the record performance of 1Q 2000, might well be arrested in the opening quarter of 2001. The easing of monetary policy in January had an immediate impact on the income statement of securities firms, which had properly positioned themselves for the anticipated policy shift. While the shift was expected, its timing was a surprise. The surprise came when the Federal Reserve abandoned a gradualist approach and front-loaded a ½ percentage point cut into the first week of the month, and then followed with a less surprising cut of equal magnitude on the last day of January. This has allowed securities firms to enjoy the benefits of lower interest rates for the entirety of the current quarter. While other factors are contributing to the improving outlook for the industry, none provides as immediate or as profound a positive impact as the shift in Federal Reserve policy.



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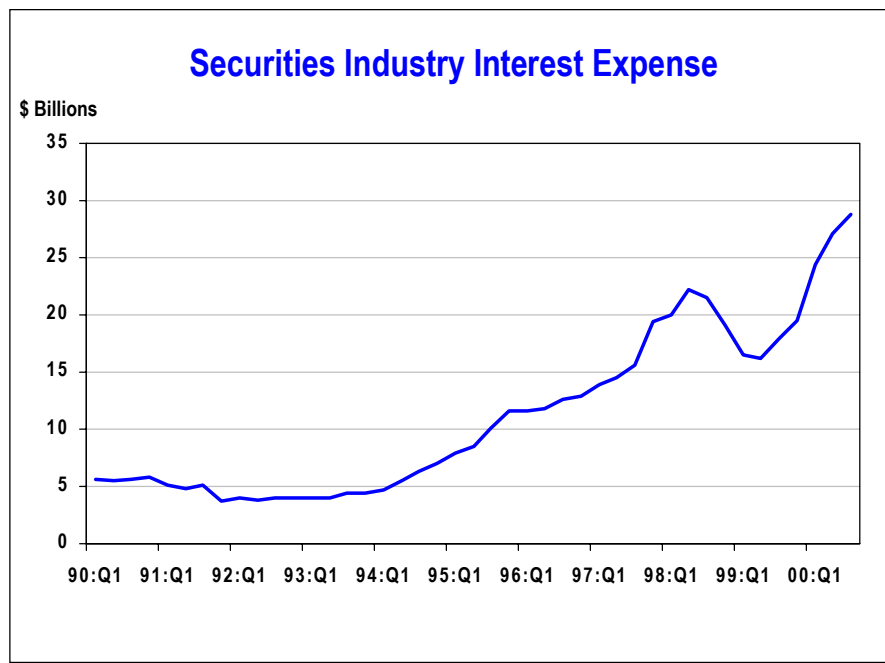
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Few industries or sectors of the economy are more interest rate sensitive than the financial services industry, and no part of the financial services world enjoys a more immediate and unambiguous benefit than securities firms. The revenues and profitability of commercial banking operations will likely be constrained for some months to come by the deteriorating credit quality of their loan portfolio and a cutback in lending as signs of a traditional “credit crunch” persist. However, no such offset to the benefits of lower interest rates exists for broker/dealer operations. The decline in short term interest rates during January was quickly reflected in lower funding costs for firms and may add as much as \$1.5-\$2.0 billion to 1Q 2001 profits. This alone should be enough to halt the deteriorating performance witnessed across the course of last year.

In addition, it would appear securities firms magnified these benefits by correctly anticipating Mr. Greenspan and positioning themselves accordingly as 2000 came to a close. Securities firms entered December with a large cash position reflecting retained earnings during a record year for profits (the lion’s share of which were recorded in 1Q 2000) and the need to pay out on what has turned out to be record levels of

ordinary and bonus compensation. With the bulk of the latter payments occurring in January, many firms held these positions in liquid, interest bearing fixed income instruments, specifically corporate bonds. When interest rates fell in January, prices of these bonds jumped adding to firms’ bottom lines. Bonus compensation, never an inconsequential amount for the securities industry, has risen sharply in recent years both in absolute amounts and as a portion of total compensation. For the bonus cycle just completed, total bonus compensation may have risen as much as 20% from the previous year (itself a record) and approached \$15 billion.

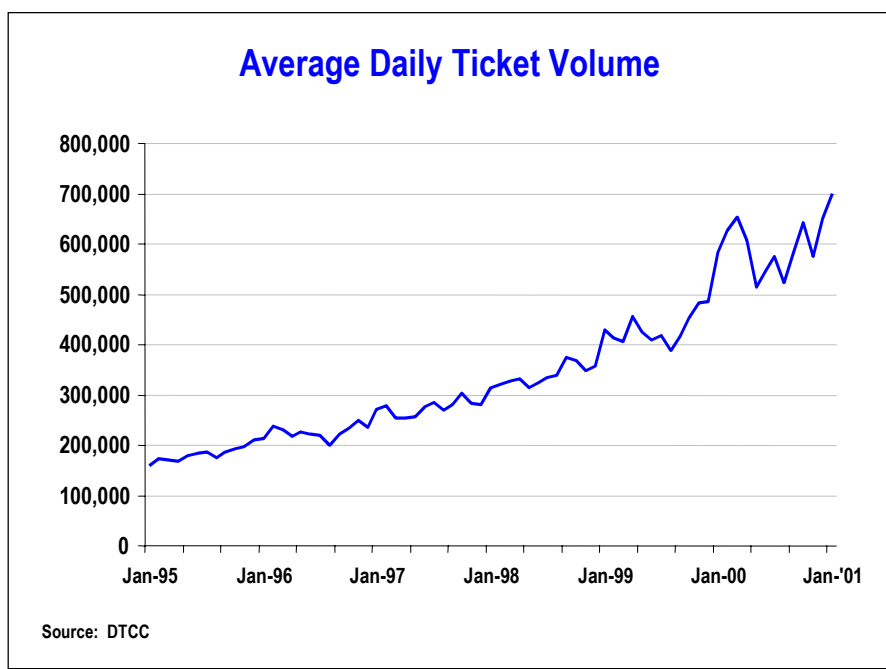
A similar “positive carry” occurred on the unsold inventory position firms held in bonds at end-2000. Firms had acquired a larger inventory position of bonds in order to provide immediacy in satisfying anticipated stronger customer demand for bonds and to a lesser extent, selected equities, once the Fed began to cut interest rates. Also leading to the larger inventories was the plunge in underwriting activity late last year. While equity issuance activity (see Monthly Statistical Review which follows) has remained moribund in the New Year, debt offerings revived in January, clearing a backlog of recently

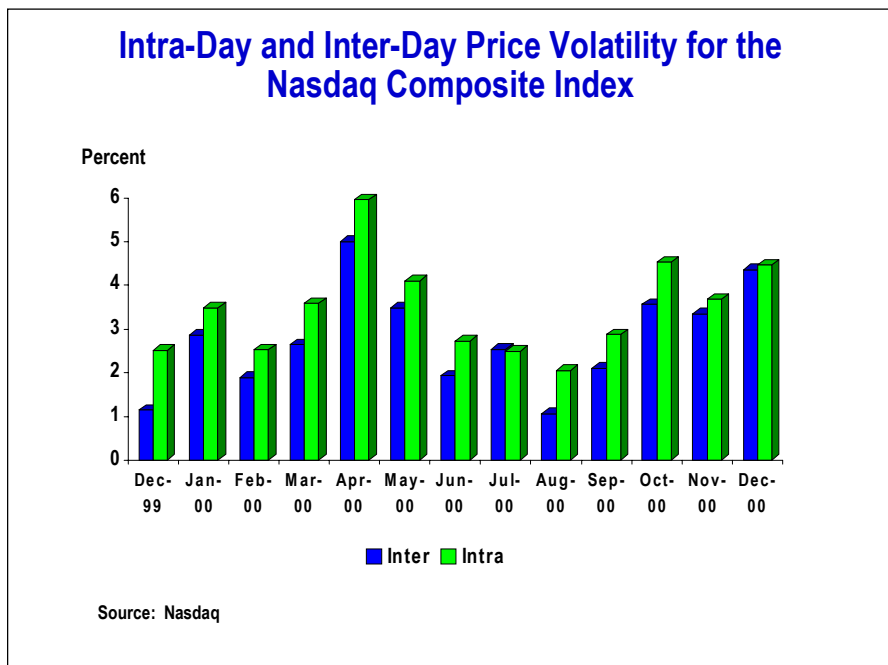
appreciated new issues, which had clogged the pipeline as 2000 came to a close.

Another boost to 1Q 2001 profitability is expected to come from higher trading gains generated for a number of reasons. First, firms appear to have expanded proprietary trading, applying additional capital to these activities in anticipation of a market rally due to expectations of a strong "January effect." This action may have been in response to mutual fund managers holding larger than normal cash positions in December (liquid assets of stock mutual funds represented 5.8% of total assets at end-2000, up from 4.4% at the start of the year) and in anticipation of monetary ease. Secondly, and perhaps more importantly, firms engaged in greater market making activity and acted more frequently as principal in trades. Some of this can be attributed to the impact of the transition to decimalization, as limit orders declined and reports of stepping ahead or "pennying" became fairly frequent.

Market trading volume also remained strong in January and February, with combined share volume of the NYSE and NASDAQ running nearly 22% above levels during the first two

months of 2000. Higher volume more than offset narrower spreads and lower fees and commission rates, and revenue from these activities continues to rise. Also contributing to better performance thus far this year, albeit modestly, are small increases in mutual fund sales revenues and growth in asset management fees. For example, cash flow into stock mutual funds was \$24.6 billion in January, well up from December, but still below the extraordinary levels during Q1 2000. Overall, total net assets of all mutual funds rose 3.8% in January from weak December levels. Partial February results indicate that this uptick in revenues related to mutual fund activity may have been reversed as the decline in the major market indices was reflected in lower values of assets under management and hence management fees. However, the trend noted during late 2000 remains intact: Individual investors have responded to a declining market and to sustained, record volatility, by discarding "self-directed, momentum investing" strategies and moving assets back into full service accounts and into funds.





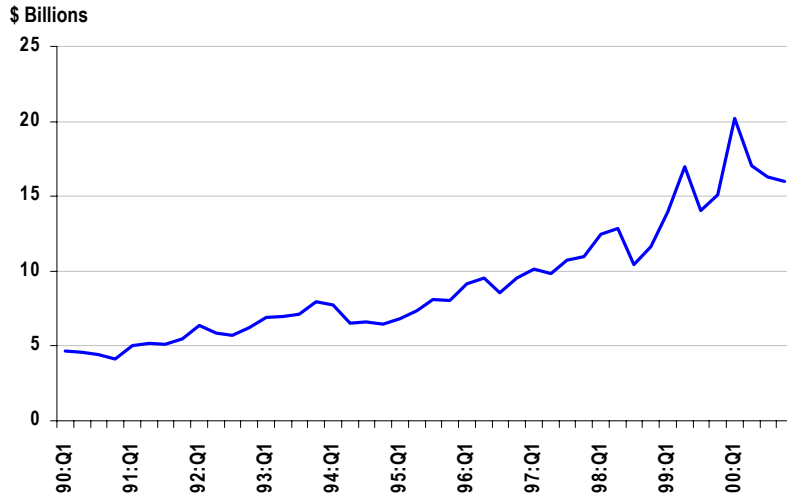
Margin interest revenues also rose as use of margin (which declined after peaking at near record levels in April 2000) began to increase again late last year. In fact, virtually all line items of firms' income statements appear to be rising, with the notable exception of underwriting revenue. For the first eight weeks of this year, total disclosed fees are running slightly ahead of 4Q 2000 levels, but a full 25% below the record pace set in 1Q 2000.

The evolution of the expense side of the ledger has been less benign, but higher costs have not kept pace with rising revenues in the first two months of the year and profits appear to be higher than expectations as a result. Total compensation and interest expense are far and away the largest expense items confronting securities firms. Our forecast for 1Q 2001 assumes that sharply higher compensation expense will be more than offset by declines in interest expense. Surprisingly, poor Q4 performance did not lead firms to trim back on bonus allocations, nor do we find any evidence of expected and, in some cases, announced layoffs in net terms in the industry so far this year. However, we expect total compensation growth to stall after the current round of bonus awards. Perhaps the view that the economic slowdown

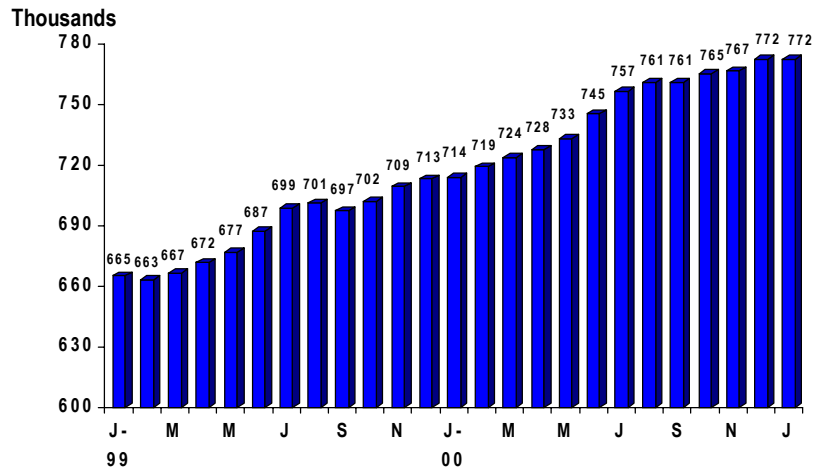
will be short-lived and the aggressive easing by the Federal Reserve dissuaded firms from moving too quickly to trim expenses.

It should be recalled too that many firms were criticized for both "over hiring" in the early 1980's and "overreacting" with deep cuts in employment in the aftermath of the market break of 1987. The growth of employment in the late 1990s has been more moderate, and there is less room for job cuts. What reductions have occurred in the industry appear largely to be related to the impact of a record 102 M&A's in the industry last year and redundancies created by ongoing modernization and the move towards greater automation of the entire trade cycle. These trends, along with the move towards a shortened settlement cycle, are part of larger market structure changes that generate new demand for employment just as older job classes are eliminated. As a result in net terms, employment in the industry appears to have reached a plateau during Q3 2000, but has not declined. Less use of consultants and temporary help may be the rule, but permanent employment appears to be stable for now. However, we expect consolidation and modernization to continue, and employment reductions may materialize later in the year.

Securities Industry Total Compensation



U.S. Securities Industry Employment



Capital spending appears to be on track for annual growth of about 12%. The financial services industry continues to be among the most rapid adapters and adopters of the revolution in information technology and planned rates of capital spending this year continue to be well above the national average for all industries. While much of the ongoing reduction in costs that systems and operational upgrades have generated have been passed on to customers (who on average continue to pay less in each successive quarter to transact trades thanks to an extremely competitive environment), areas such as communications expense and data processing costs are expected to continue to decline.

While prospects are somewhat brighter than they appeared as 2000 came to a close, it is unlikely that the industry can continue the string of successive annual records in profits and revenues during 2001. In addition, the change in the direction of quarterly results, which appears underway in 1Q 2001, is far from a firmly established trend. Tempering our relatively optimistic view are caveats that are true for both the securities industry as well as for the performance of the overall economy in recent months. Due to seasonal factors and other transitory effects, performance for December appears worse than it may actually have been, while January results (in your rearview mirror) may not be as strong as they appear. By contrast, interpreting February outturns, once full results are in, appears to be a relatively straightforward task.

Comparing the current situation with past historical experience could draw still better, but substantially less reliable, inferences. If this reversal of fortunes of the securities industry is sustained, it may presage better times ahead not only for the market, but for the economy as a whole, at least that is if you believe that past correlations provide any indication of future directions. It is generally conceded that equity market performance tends to be a good coincident, if not leading, indicator of performance in the overall economy. Stock market rallies tend to begin at or prior to the trough of downturns or recessions in the real sector. Similarly, the performance of the securities firms may be a coincident or leading indicator of market performance. If all of these tenuous assumptions hold, the market might well be poised for better times during the second quarter, despite expectations that corporate earnings growth will remain negative and overall economic growth anemic until the second half of the year.

NOTE: For a detailed analysis of year 2000 securities industry results and 1Q 2001 outlook, please purchase the upcoming March issue of *Securities Industry Trends*.

Frank A. Fernandez
Senior Vice President, Chief Economist,
and Director, Research

UPDATE ON MARKET STRUCTURE ISSUES

The securities industry has and will continue to undergo rapid and profound market structure changes and the following is intended to provide SIA members with an update on the progress of a number of these issues. The SIA's Market Structure Committee has been extremely active in these areas as it analyzes these changes and develops consensus positions on these matters. In the past year the Committee's activities have included, but not been limited to, comment letters on the SEC's market fragmentation concept release and rescission of Rule 390, market data release, proposal to establish an intermarket linkage plan for listed options, the order routing and execution disclosure proposals, limit order transparency and the approval of SuperMontage, and the proposed firm quote and trade-through disclosure rules for options. While substantial progress has been achieved, 2001 promises to bring at least as much activity on market structure issues. Summary comments on some of these issues follow:

Decimals Update

Thus far the process of implementing decimalization has proceeded as expected. However, a number of issues concerning the impact of decimalization have been raised. While it is premature to attempt to assess the impact, given full decimalization has not yet occurred, it is worthwhile to enumerate these concerns and open issues in order to assist the process of forming a deeper understanding and an industry consensus.

Nasdaq

Saturday February 24, 2001 concluded the Nasdaq Extended Point-To-Point testing for the decimals pricing conversion. Nasdaq important notices regarding testing and implementation can be found on the SIA Decimalization web site or at: www.nasdaqtrader.com, it is listed under hot topics for Decimalization. Additionally, you can contact the NASD Decimalization Program Management Office at: www.nasd.com the information is listed under Decimalization, or via telephone: 888 227-1330. The initial phase in for Nasdaq securities is scheduled for March 12, 2001 with 15 securities, followed by 180 securities on March 26, reference the web sites above for a

listing of these securities. The remaining Nasdaq equity securities will convert on April 9, 2001. Options will convert when the underlying security converts.

Listed Securities

All listed equities and their associated options are converted to decimal pricing. Related information is available via the exchange web sites directly or it can be accessed via a link from SIA's Decimalization web site at: www.sia.com/decimalization. Issues that are traded on regional exchanges as primary listed equities, that also trade on Nasdaq, will continue to trade in fractions and will be converted when the security converts on Nasdaq. Check the SIA web site or the regional exchange notices for a listing of these issues. This notice is also available via a recorded message at 212 720-0678.

A meeting was hosted by Chairman Grasso of the NYSE on Friday, February 16, 2001. The meeting was in response to recent complaints about changes in trading behavior since the full conversion of listed securities on January 29, 2001. There were about fifty people in attendance. Two main topics were discussed, the first was the issue surrounding the lack of market depth in the specialist book (the ability to see only hundred share lots as opposed to thousands prior to the penny MPV) and the second was the complaint that NYSE specialist firms and other investors may be profiting from institutional transactions by stepping in front of them with a price improvement of a penny. A task force was convened to study these issues and is expected to forward its findings to the NYSE in early April.

Some market participants are concerned that there are a number of unintended consequences resulting from the implementation of decimalization including: the decline in the number of limit orders, the erosion of market liquidity and the lack of market depth on the specialist book as increased transparency reduces anonymity (and hence the desire of institutional investors to expose the full extent of their orders). Even if liquidity were constant, market depth on individual issues would be reduced, since it is now spread across more price points. It is also important to note that there is a concern that market liquidity risk rises in a downturn and more specifically, when there is a credit "crunch"

as is now the case. One widely shared view is that while these concerns deserve attention, it would be premature to draw any conclusions given the limited experience we have to date with the impact of decimalization.

T + 1 Settlement Update

The industry's preparations for the move to a T+1 settlement environment are well underway. In July of last year, the SIA published its T+1 Business Case Report outlining the "ten building blocks" and implementation time line necessary to successfully achieve this goal.

Arthur Levitt, in a letter recently written to executives of securities firms, investment advisors, and transfer agents, strongly urged them to immediately begin implementing the changes needed to prepare for the shortening of the settlement cycle to T+1. Citing the SIA's efforts already underway, Levitt called the achievement of T+1 and straight through processing "critical to the continued success of our markets." In order to accomplish the infrastructure changes within the timeframe outlined in SIA's T+1 Business Case, Levitt stressed the necessity of firms immediately focusing on their preparations and allocating the necessary resources to the project.

Currently, the SIA's T+1 Steering Committee and its associated subcommittees have undertaken the effort to translate these business case building blocks and roadmap into the next level of detailed project plans. To this end, The Capital Markets Company (Capco) has been engaged to facilitate the coordination and production of plans that will directly reflect the milestones and tasks that have been identified as necessary to achieve T+1. These plans will also provide a "key" link to your firm as you conduct your own internal planning processes.

As each of the ten building blocks are completed and tested they will go "live" in daily production. The intent is to be operating within the new infrastructure by mid-2003 and then test and convert to T+1 by mid-2004. This will necessitate your firm keeping pace with the industry's progress.

SIA is asking firms to designate a T+1 Project Manager(s) in much the same way as we did with the Year 2000 initiative. This individual should

register on the SIA's web site at (www.sia.com/t_plus_one_issue/) to ensure all the latest information, requirements and updates are communicated to your firm in a timely fashion.

Market Data Update

With regard to the market data situation, the SEC Federal Advisory Committee on Market Information, chaired by Dean Joel Seligman, meets again on March 1 to hammer out its recommendation on issues such as fair fees for market data and plan governance. An overview of this meeting will be found in the March *Research Report*. An overview of the Committee meeting last December can be found in the December 2000 *Research Report*. This Committee will be issuing its recommendations to the SEC in the fall of 2001. Finally, in this issue there is an overview of the "Data Vendors: Challenges and Opportunities" panel from the SIA Market Data Conference. In that panel, vendors talked about the strategies they will employ to be competitive in the rapidly changing market data industry.

Disclosure Rules Update

The SEC is currently working on three things with regard to the new Rule on Disclosure of Order Routing and Execution Practices, Rule 11Ac1-5. First, the staff sought and received approval for an across-the-board postponement of 30 days of the first phase in date for the rule, from April 2 to May 1. This delay is to give firms time to review the joint SRO plan that will be issued shortly (that provides the technical specifications for providing the information required by the rule), to review the interpretative guidance also to be issued shortly by the SEC, and to program their systems. Second, the SEC indicated to Nasdaq that it will entertain further exemptive relief for smaller market centers, to afford Nasdaq additional time to build the capability to report for them. Third, the SEC also expressed interest in granting exemptions for three types of orders and asked for the SIA's help in writing the letter requesting the exemptions. In last month's *Research Report*, we discussed the recent SEC Report on Execution Quality that attempted to compare the quality of executions on the NYSE to those on the Nasdaq.

Judith L. Chase

Vice President and Director, Securities Research

DATA VENDORS: CHALLENGES AND OPPORTUNITIES

Highlights From SIA's Market Data Conference, January 31, 2001

The following is not meant to be a transcript of the session, only an overview, and so does not reflect direct quotes of the participants.

Participants:

Moderator: W. Leo McBlain
Vice Pres., Brokerage Information Services Group
ADP Brokerage Services Group, www.adp.com

Charles J. Garcia
Marketing Manager, Straight Through Processing
Bloomberg Financial Markets,
www.bloomberg.com

Mark A. Minister
Executive Vice President
Bridge Information Systems, www.bridge.com

Bernard W. Weinstein
President and Chief Executive Officer
ILX Systems, www.ilx.com

Devin N. Wenig
President
Reuters Information, www.reuters.com

McBlain began the session by saying that market data vendors are positioned in between the markets and the brokerage firms who use the data. Many have said that the distribution of market data is a function that they would like to and could perform themselves. Nonetheless, vendors have survived for many years. He took a look back from the perspective of vendors, and talked about who was participating in the game early.

He said that there have always been three significant drivers in the business. They are: 1) the regulatory driver, initiatives out of Washington that force change, 2) the technology that serves the market, and 3) the product creativity and marketing provided by vendors.

Looking out over the past thirty-five years, he said that one of the first technology breakthroughs was the ticker. Before the phone and the ticker, there were anywhere from 30 to 60

stock markets in operation as regional entities. No one knew whether the price in one city matched the price in another city. It was the ticker that began putting out a continuous stream of last trades. The New York Stock Exchange (NYSE) benefited from this because they came up with their own ticker network. Suddenly, they were able to reach beyond their own trading floor. When the NYSE began to be able to telegraph their trade information, there was big shrinkage in those regional markets.

In terms of the early vendors, Scantlin Electronics was the vendor to capture the ticker and put its contents in a database. One of the first inquiry and retrieval devices was the keyboard. You would type in the symbol and get the last trade on that stock. Ultronic Systems came up with the "Nixi Tube," a vacuum tube, which allowed you to punch in a symbol and get three characters, not just the last price for example, but the bid and ask prices as well. Teleregister Corporation used the cathode ray tube to put up as much information as possible on a three-inch display. This was the system being used for airline reservations. Bunker Ramo expanded this display from three inches in order to continuously display prices.

GTE Information Systems was the company to use the principle that news moves markets, letting news roll off the desk unit as well as the ticker. Scantlin then built out the Quotron system. Up until this point, the reliability of information was questionable, and quotes would actually flicker. This was the beginning of the "Second Port Era." Brokerage firms that previously did paperwork at the local offices were forced to computerize, based on the ability of the vendor to emulate an IBM terminal. Now on the same desk unit, you were able to enter orders and see account information for a new degree of functionality. Firms now had to have one vendor across offices for uniformity of display. This created more centralized decision-making, and led to the idea of long-term contracts.

Information access continued to expand, leading to 90-day news retrieval, which was a vendor initiative by Dow Jones and Bunker Ramo. At first, market participants weren't sure why this would be useful, and the system went for two

years without any orders. Then Dean Witter put it into all of their offices, and then everyone had to have it. This also changed the ratio of desk units to brokers. Previously, the terminal would be on a swivel with between 3 and 6 brokers using each one. As the information increased, the need for dedicated terminals arose.

Telerate Corporation found that other financial information needed to be exchanged as well, and displayed interest rates and other information. At first, the need for this was not seen either, because those numbers did not change during the day and could be read in the newspaper. With the development of a mechanism to disseminate it, these numbers would eventually begin to change during the course of a day. Technical Data, now part of Thomson Financial, came up with the whole idea of disseminating research information. First Call emerged because distribution was costly, and they became a consolidated provider. Monchick Webber began to provide analytics for options on a central system.

Overseas, Reuters, the news company, was distributing news over copper wire at 75 bits per second. This was an expensive distribution system, so they came together with GTE, which had developed a "multiplexer" system. Now there could be 12 channels on each wire, which could be used to provide market data on terminals. Reuters also began providing a system to deal in currency trading. Reuters was the SIAC of Europe. It then began getting into trading systems, like Antibco.

Years ago, Mike Bloomberg began exploring the idea of distributing bond information. He had access to the prices, and took the approach of figuring out what the trader needs to do his job. Bloomberg incorporated analytics, and also started a news service. This is another case where the creativity of the vendor started something out of nothing. Meanwhile, along came the era of the smart desk unit, even before personal computers. People began coming out with microprocessors. Quotron built the Q1000, which had a microprocessor and the ability to do calculations.

Then IBM got into the smart boxes business. It was a computer, System 1, that had a teletype video terminal. Merrill Lynch and IBM joined

together to create International Market Net to move into the market data business. Apple was also creating graphics and a user-friendly interface at this time.

The vendor world was a difficult and expensive one. No longer, however, were vendors providing proprietary hardware in the form of the desk unit. It gave way to third party software, and to the MS DOS Standard Operating System. The vendor revenue base began eroding. However, as vendors were considering themselves to be more than data conveyors, they began moving into the trading world as well, particularly Reuters, with Instinet, and Bloomberg.

Barriers that had previously existed began to dissolve with standard protocols such as TCP/IP. Data no longer needed to be centralized to be shared, there could be point-to-point connection. HTML came into use, screens had graphs and flexibility, and with the world wide web, masses began demanding user friendly interfaces. Vendors were forced to remake themselves, and clarify: what is their value?

Today, there is still a big need for broad data collection and consolidation, bringing information from the various market centers, scrubbing it, and presenting it in a consistent and reliable way. Vendors have economies of scale, they can share their costs across the whole user base. They also have scalability. The capacity of market data vendors has been expanded. In terms of reliability, an "outage" today is a traumatic event, almost unthinkable.

There are also many challenges facing the vendors. These are created by: the traffic increases, the new TRACE system, extended trading sessions, the Internet, new competition, decimalization, industry consolidation, XML, globalization, and the impact of regulatory changes such as Regulation Fair Disclosure. The only certain thing is that the industry and the markets will not in the future look as they do today.

McBlain then introduced the participants, and asked each to describe their organizations and what strategies made them successful. Garcia from Bloomberg began by mentioning that it is refreshing to address a group of people from

companies that are more than two years old. Bloomberg does many different things for different people. But if there is a commonality about what everyone does, it is fair to say that people rely on Bloomberg for market data. Reliable, fast, trustworthy information dissemination helped Bloomberg to be successful, as well as the fact that Bloomberg sends you a bill that you can understand. Previously, companies would wait for market data bills, hoping they didn't exceed their budgets, but they couldn't be sure what that bill would be.

Bloomberg's business plan has been altered a little bit. The demands that they are responding to now could be a little different than the ones they were responding to ten years ago. Ten years ago, they had the analytical service combined with market data. You fed the data into an analytical application, and made an investment decision. That model has not changed, but they are now able to capture and enable more of the trade cycle than before. Before, you would make your investment decision, and your fingers would leave the terminal. Now, with the automation of the trade process, Bloomberg offers a platform, and your fingers stay on the terminal after the investment decision is made. They offer interconnectivity with the broker/dealer community, the trade is sent to wherever you need it to be, it is acknowledged and confirmed, and sent back to the front end and to whatever post-trade constituent custodian bank or industry utility is required. They are now a solutions provider for trade automation needs throughout the whole cycle, in pre-trade, in trade execution, and in the post-trade environment.

Minister from Bridge Information Systems then said that the "old Bridge" was founded in the late 1960's. In the last five years, Bridge has changed a lot. It bought many companies. Before, Bridge was primarily a U.S. equities business. Now it is a global market data provider that serves high-end professional users in addition to all the other segments. Bridge knows that many of their customers' livelihoods depend on receiving accurate and timely market data. Bridge has expanded its capabilities and service offerings, and capitalizes on the fact that the wires connecting them to broker/dealers go in both directions. Still, significant challenges remain.

Weinstein from ILX Systems said that the key for ILX, and for any company, is to have staying power, to grow "organically," and to be profitable. Reliability is a differentiator, but the key differentiator is the way in which the company reacts to technological change. ILX is fundamentally a technology company, and ILX looks at change as an opportunity.

Wenig from Reuters Information said that Reuters has four divisions. There is Instinet, there is Reuters Information, there is Reuters Trading Solutions, and there is Reuters Space, which is the place for new Reuters ventures. The company's culture has changed in the past nine years since Wenig has been there. There is more energy and enthusiasm for truly global ventures and decision-making than ever, they are embracing technology and really exploring what their clients want. They are trying to help the industry move toward open standards. Previously, Reuters made its own hardware, but business increases with open standards, and the company is able to move up the value chain. They have made large investments in Internet technology.

McBlain asked the panelists to respond to a question about the most significant changes that each respective organization has had to deal with in the past five years, and what are the immediate strategies to deal with regulatory and market structure changes currently reshaping the markets. Garcia said that for Bloomberg, the question of what they will not pursue is as important as what they will pursue. The ventures they will pursue are based not on abstract technological innovation, but on what the client demands and will really be able to use. The convergence of pressures, such as T+1, has not made Bloomberg lose sight of the fact that customer service is of the utmost importance. Bloomberg is striving to change its business plan with the technological changes quickly enough to be extremely competitive, while retaining a personal touch with their customers. In terms of priorities, Bloomberg wants to move quickly enough to beat the competition in meeting the straight-through-processing needs of its customers.

Minister from Bridge then said that in the "old Bridge," the market data that they delivered was

their product. Now Bridge is working much closer with the clients to tailor services. Bridge has a "Tsunami project," given that there is so much data and there will be even more. Bridge is capable of handling 50,000 transactions per second, and internally as many as 100,000 transactions per second. Bridge doesn't think that any of their clients will be asking for that much, so the key is to discover what they are using the data for, and what would be the most beneficial package and presentation for that client.

Weinstein from ILX said that ILX is managing cultural change within the company. They have experienced extremely rapid growth of over 100,000 new users over the past five years. The roots of ILX are entrepreneurial, and ILX is committed to maintaining that culture. They consider two metrics of success to be important. The first metric is gains in market share. The second metric is customer retention. ILX has a 98% customer retention rate, which, with industry consolidation and bankruptcy, is as close to perfect as a company can get. ILX wants to continue to be a lean, nimble organization that is customer driven.

Wenig from Reuters made the point that the more things change, the more they stay the same. Many challenges in the past have looked insurmountable. For example, when personal computers came out, many in the vendor community thought that they would be disintermediated because vendors no longer made the boxes. Some wondered how vendors would be able to handle 400 messages per second. When the Internet came alive three years ago, some said that that was the end for vendors because distribution could no longer be controlled. None of these challenges turned out to be insurmountable. The Internet and Internet technologies is a great vehicle for growth for Reuters. Reuters encourages and contributes to open systems and open standards. Reuters has always been open, embracing off-the-shelf technologies. Reuters believes it has staying power.

McBlain then mentioned that he chairs the Financial Information Forum, which deals with information systems issues, and one of the biggest is increasing market data traffic as a result of

decimalization and other changes. Different constituencies have different things to say about it. SIAC says that it is in good shape capacity-wise, Nasdaq is expanding capacity, and OPRA has new capacity. The vendors are saying that they are ready. The users, however, the broker/dealers, are asking, "What do we have to do to be ready?" What advice would the panelists give them?

Minister of Bridge said that sending 10,000 or 15,000 messages down the line to brokerage firms could bring some of those organizations to a halt. The question is to find out what data an organization needs, and to manage the data distribution at the client site. Weinstein of ILX talked about how long everyone had prepared for decimalization. While the preparation is expensive, it is also the cost of doing business. The lines must be upgraded. ILX has created enhancement software called TURBO, but this is the tip of the iceberg. Increased listings and volatility are also driving volume through the roof.

Wenig of Reuters said that Reuters has a comprehensive capacity plan in place, and will always deliver every tick to those who need it. It is, however, necessary to ascertain what the client needs in reality. Working with regulators is also crucial, because some regulatory frameworks are arcane. What do vendor display rules mean in a world of 30,000 messages per second? The human eye can't pick up the update rate of a quote on a screen. Vendors need the flexibility from regulators to make marketing and packaging decisions that our clients demand. If vendors get it wrong, clients will vote with their feet. Competition is intense in this industry. That is how segments will get served.

Garcia of Bloomberg noted that it was hard to establish connectivity in the early to mid 1990s because of disparate protocols. Therefore, Bloomberg encourages "competition" among broker/dealers, which are joint initiatives that will help the whole industry become more efficient, as in the promotion of common standards. Bloomberg listens to its clients about what are their preferred liquidity sources, by what standards do those broker/dealers want to

get to those liquidity sources, and Bloomberg responds.

The next question from the audience was for Wenig of Reuters. What are the regulatory and structural issues restricting growth, and do other panelists feel the same way? Wenig said that the vendor display rules, emerging standards in fixed income, and OPRA emerging standards put potential constraints on the packaging and delivery of data. The market demands flexibility. Competition should be able to decide what data is required.

The next question was whether or not the panelists foresee users building their own tick plants, or going joint venture with them on certain strains. Weinstein from ILX said their customers take feeds from them. ILX gives the customers a set of APIs and the raw data, and they develop their own applications tool kit. Minister from Bridge said that their customers are not quite at the ticker plant level. There are clients who do take direct exchange tickers. As data traffic grows, he doesn't think that they will see a lot of customers wanting to get to that level. Garcia from Bloomberg said that their clients want an enabler. They want the ability of APIs to take the data from one place and get it to another place, and to take a trade, feed it into a trade order management application to be sent somewhere else.

A comment from the audience was made that the panelists' organizations as a group have been great facilitators of market transparency from a fixed income perspective. The question was then asked about the plans of those organizations to provide fixed income data to retail groups. Wenig from Reuters said that they partner with clients to distribute data that crosses asset classes to online retail communities. They also deliver a limited set of data directly on their website. This kind of information is leading to the markets' acceptance and uptake of true retail trading in fixed income. There is a market for this.

The next question from the audience was about vendor strategies for continuing to add value in the new age of open formats. Minister from Bridge said that all vendors deliver data, and that differentiation is in the service and quality that vendors offer. The work is at the

display level, how you can access the data you need. As the data quantity grows, it becomes harder to get the right data in front of the user. Weinstein of ILX said that the idea is to turn the data into information through the correct presentation of data and user interfaces, and the support provided to using those systems. He said that if market data had in fact become a commodity, ILX would not have seen the growth in market share that it has. Garcia from Bloomberg said that Bloomberg adds value to the data through the automation of the trade cycle, ending with the deposit of the money in the custodian bank.

The next audience question was about an interview with *Securities Industry News* that was given by Wenig of Reuters relating to SROs potentially precluding the efficiency of market data management and administrative cost savings. What is the global fix for administrative costs for broker/dealers who may be using multiple feeds? Wenig said that there needs to be standardization of the way that exchanges and vendors manage, bill, and administer market data. Common standards will squeeze out indirect costs of the fragmented system. The SEC Advisory Committee on Market Information is looking into those issues. As of now, professional users pay 85% of the costs of market data.

The next question was relating to the fact that this market data customer found that screen refresh rates were his organization's biggest exposure to increased volume from decimalization, and it became necessary to invest in upgraded video cards, despite the fact that their computers were new. He asked the panelists about efforts in the labs to look at the content of the messages coming down. Wenig said that Reuters assumes infinite bandwidth at zero cost to improve the user experience. Weinstein said that ILX is working to improve throughput and lessen the load on PCs, including looking at pattern recognition of trends with graphical representations.

The next question was about the effect on vendor margins when suppliers and customers are going after some of the same value-added with global exchanges and the like. Weinstein said that ILX has scale economies, spreading the

costs over 160,000 users. Minister said that there is indeed margin pressure because of those factors.

The next question related to the fact that over the last six months, there have been 20 new direct connect vendors to SIAC, whereas before there were only 55. Wenig said that the value proposition actually expands with the complexity of the world. Reuters is encouraging common Netscape or Microsoft browser use, as opposed to a Reuters browser, because increased efficiency is good for Reuters margins as well as customer profits.

The last question of the session related to parallels between the business-to-business world, particularly with regard to international opportunities and standards. Are the vendors looking outside the financial trading world for ideas? Garcia said that with regard to global business, the key is to have the content to sell in the particular country in question, to localize strategy. Over the last two to three years, cross-border communications have improved. Local customer service, however, with local salespeople, is crucial. Wenig said that the point of the

question was well taken, that the market data business is not unique. He met someone from Mastercard International, realized that they have amazing transaction volumes, and began trying to hire people from there. They would also like to explore opportunities to partner with other B-to-Bs that are simply supplying bandwidth into organizations. Weinstein said that ILX thinks of itself as an information systems company, providing an integrated financial information platform, and learning from models in other technology businesses. Wenig said that Reuters fully supports the cross-pollination of standards between the B-to-B world and finance. What is most challenging about global business is understanding cultural differences. Reuters Space is exploring new opportunities involving XML with B-to-Bs. This discussion marked the end of this session with the vendors.

Judith L. Chase

Vice President and Director, Securities Research

THE NEW BASEL CAPITAL ACCORD: AN OVERVIEW

The Basel Committee on Banking Supervision, of the Bank of International Settlements, is a committee comprised of banking supervisory authorities in the G-10. The Committee has released a proposal for a new capital adequacy framework that would replace the prior Accord, which was issued in 1988. (An amendment in 1996 permitted banks to use their internal models to determine capital adequacy for market risk.) When finalized and adopted by national supervisors, the new Accord will govern all the business undertaken by financial holding companies, including that of their broker/dealer affiliates.

The text of the new Accord and accompanying documents, which can be found at www.bis.com, is quite complex, running to more than 500 pages. Very generally, the Accord consists of three “pillars,” which are designed to mutually reinforce one another. The first pillar deals with minimum capital requirements. The second pillar deals with supervisory review, and the third pillar deals with market discipline. The Committee advises that the Accord will not be considered to be implemented if all 3 pillars are not present. The Committee anticipates finalizing this Accord by the end of 2001. The Committee anticipates that the new Accord will be implemented in the year 2004. Comments on this proposal are due by May 31, 2001.

Regarding Pillar 1, the biggest change from the 1988 Accord has to do with Pillar 1’s new approach to credit risk, as well as setting capital requirements for operational risk. For credit risk, the proposal gives banks a choice between a standard approach, using risk-weights set by

bank supervisory bodies, and an internal ratings-based (IRB) approach. In the standard approach, exposures to counterparties will be assigned risk weights that are based on assessments by external credit assessment institutions. The IRB approach would allow firms to use their own models and estimates with regard to the probability of default associated with a given counterparty. **It is important to note, however, that those who choose the IRB option will likely be subject to increased disclosure requirements under Pillar 3.**

The same type of menu structure is envisioned for operational risk measurement. Measurement of operational risk, however, is a concept that is still in the process of being clarified by the committee. Three approaches are currently on the table: basic indicator, standardized, and internal measurement, the last of which is considered to be the most sophisticated.

Pillar 2, related to supervisory review, requires supervisors to ensure that each bank has internal processes that effectively assess capital adequacy, given that bank’s unique risk environment. Particular emphasis is placed upon senior management involvement in ensuring that internal processes are in place to make sure that capital is commensurate to the risks being run. Pillar 3 seeks to enlist market discipline through the disclosure to other market participants of a bank’s capital, risk exposures, assessment and management processes, and capital adequacy.

Judith L. Chase
Vice President and Director, Securities Research

MONTHLY STATISTICAL REVIEW

U.S. Equity Market Activity

Stock Prices - What a difference a day makes. Technology stocks tanked in the first trading session of the year, dragging the Nasdaq Composite down 7% to its lowest close since the beginning of March 1999. Just one day later, Nasdaq stocks surged 14%, a single-day record, after the Fed unexpectedly slashed the Fed funds rate by 0.5% in a rare between-meetings move.

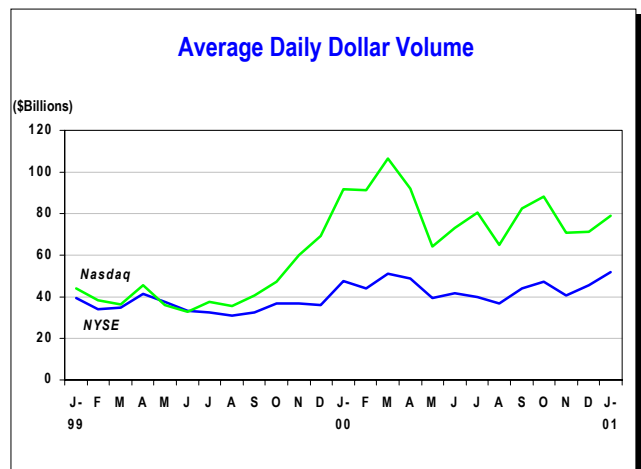
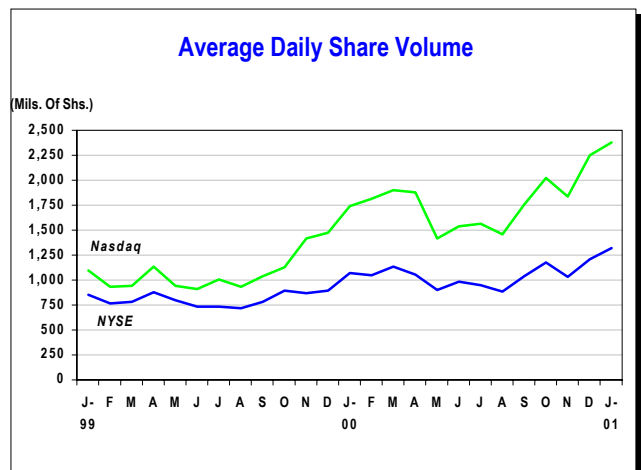
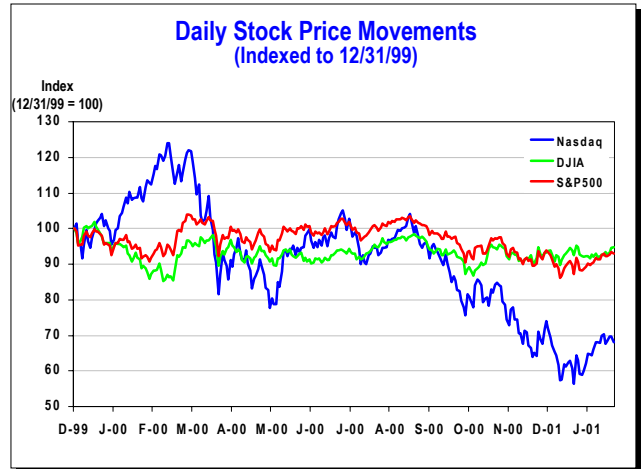
Market action was choppy through the course of the month, as a steady stream of disappointing earnings news and economic data led some to believe the downturn would be worse than expected, while others grew optimistic that conditions would improve as the Fed cuts rates further this year. Indeed, the Fed lowered short-term interest rates an additional 0.5% on Jan. 31 in a move widely anticipated by most investors.

For the month, all major stock market indexes ended up from the previous monthly close for the first time since last August. The tech-heavy Nasdaq Composite gained 12.2% in January, while the S&P 500 increased 3.5% and the Dow rose 0.9%. The January rally was short-lived, however, as the three major market indexes in February gave up all their gains for the year.

Share Volume - Investors continued to turn over their portfolios at lightning speed. On January 3, a record 3.2 billion shares changed hands on Nasdaq, driving the average daily volume for the month up 6% to a new monthly record 2.38 billion shares, from December's prior record 2.25 billion shares per day.

The Big Board also registered a monthly record average daily volume in January, climbing 10% to 1.33 billion shares daily from the previous record 1.21 billion per day in December.

Dollar Volume - The torrid trading activity and rising prices in January drove up average daily dollar volume. On the NYSE, the value of



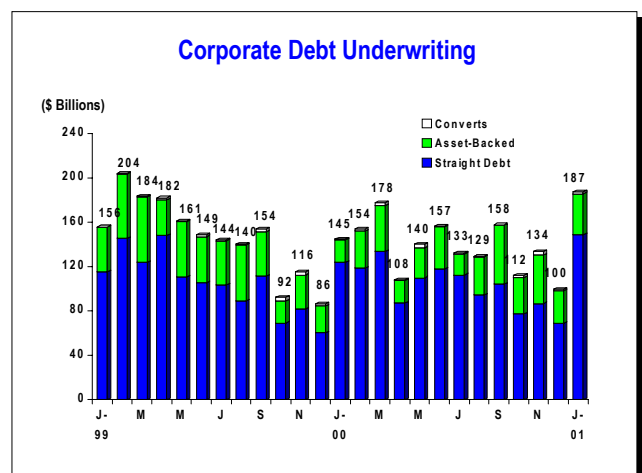
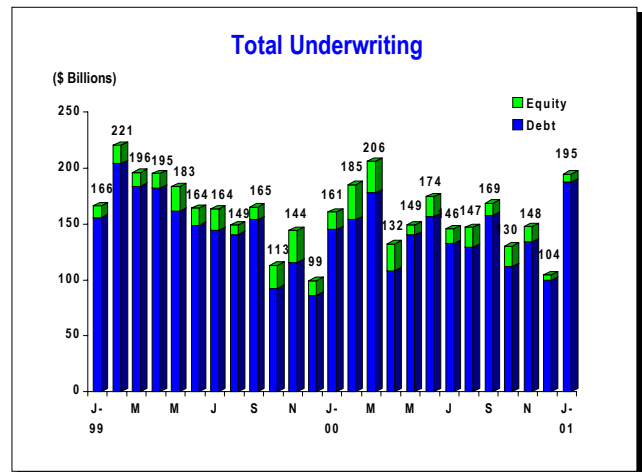
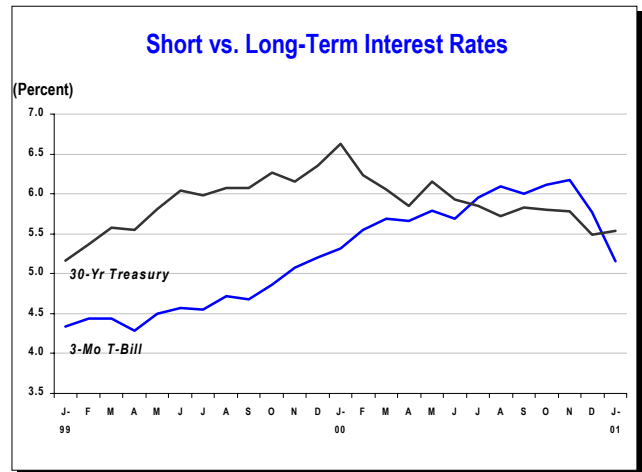
trading climbed 14% from December's level to \$52.0 billion daily in January, breaking the prior record of \$51.0 billion per day set last March. Daily dollar volume in Nasdaq stocks averaged \$79.0 billion daily in January, an 11% improvement over December, but still 26% below the record \$106.4 billion daily record also set last March.

Interest Rates - Naturally, the two interest rate cuts by the Fed in January drove down yields on 3-month Treasury bills. Three-month T-bills slid 62 basis points from December to 5.15% on average in January. Meanwhile, the yield on 30-year Treasuries increased 5 basis points to 5.54%. Thus, the spread between the 3-month and the 30-year Treasury widened to 39 basis points, as the long bond provided a better yield than short-term securities for the first time in seven months.

U.S. Underwriting Activity

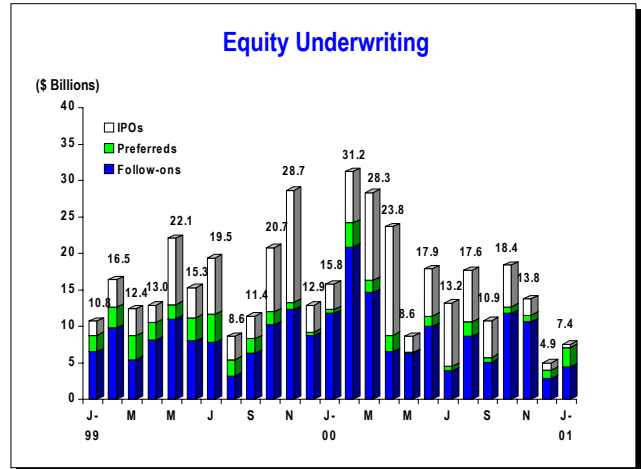
Total Underwriting - New issuance of corporate debt and equity in the U.S. market slid 6% in 2000 to \$1.85 trillion from 1999's record \$1.96 trillion. Dollar proceeds, which sank to a 2000 monthly low of \$104.4 billion last December, surged 87% in January to \$194.8 billion. That was the strongest monthly showing since March 2000's IPO-enhanced total of \$206.3 billion. However, optimism has now waned with February's calendar being sharply pared back, as both postponed deals have risen rapidly, and withdrawn deals have skyrocketed. Still, a few big deals got placed in February, such as KPMG's \$2 billion IPO.

Debt Offerings - Corporate debt underwriting in 2000 declined 7% from 1999's record volume of \$1.77 trillion to \$1.65 trillion. This was the lowest annual total since 1997, when \$1.16 trillion was offered. In January of this year, new issuance of corporate bonds in the U.S. surged to their highest monthly levels in 23 months -- \$187.4 billion, almost entirely due to straight corporate bonds. Convertibles and asset-backed bond issuance of \$1.5 billion and \$37.1 billion, respectively, were quite strong compared to December, due to a friendlier

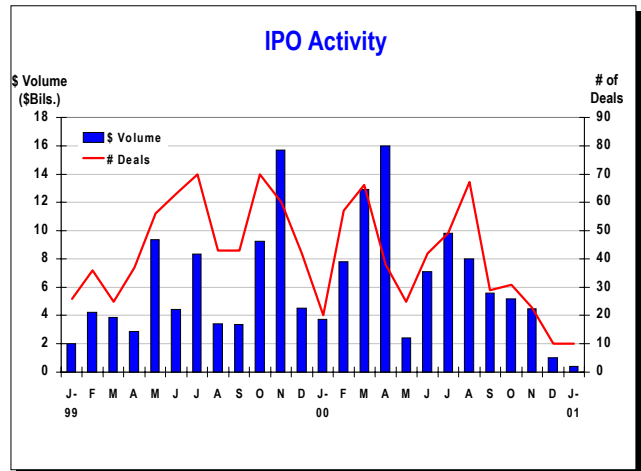


interest rate environment. Highly liquid and thus highly rated issues were of no small help such as the \$5 billion or so mega deals by such big ticket issuers like Citigroup and Ford.

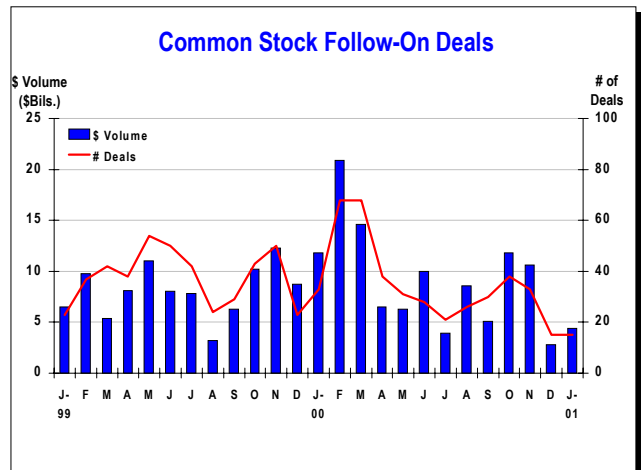
Equity Underwriting – New issuance of common and preferred stock climbed to a record \$204.5 billion in 2000 from \$191.7 billion in 1999. The volume record was set despite a dismal fourth quarter posting. Total equity underwriting in January 2001 increased to \$7.4 billion, up 51% from December’s \$4.9 billion, albeit last year’s record low of new equity offerings. Initial public offerings were barely non-existent at \$0.4 billion in January, the slowest monthly pace in over a decade (10/90).



Foreign issuers keep buoying the market, for both debt and equity, such as two foreign IPO ADRs accounting for a very strong percentage of January’s total IPO dollar value.



Follow-on underwritings rose 57% to \$4.4 billion in January from December’s \$2.8 billion, albeit again a monthly low since October 1998. Oklahoma’s The Williams Companies, alone, accounted for one-fifth of the value of all of January’s dollar volume in these secondaries.



Preferred stocks were popular, as were converts, as hedges for both issuers and institutional investors due to falling rates and volatile equity markets. Preferred stock underwritings more than doubled to \$2.7 billion in January from December’s \$1.2 billion; this was also an 11-month high for preferred offerings.

NOTE: Annual revisions to U.S. corporate underwriting data from 1990-2000 are available on SIA’s web site under “Selected Industry Statistics” at <http://www.sia.com/reference/materials/pdf/keystats.pdf>.

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