New Electronic Options Market Is Bringing Changes to Industry

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OPTIONS REPORT

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This isn't your father's options industry. In fact, it might not even be your older brother's.

Old-fashioned options exchanges, and brokerage firms that specialize in options, have been forced to change rapidly in recent months as they face multiple problems, including regulatory pressure, new competition and investor lawsuits.

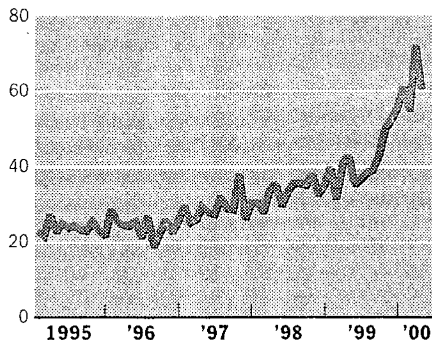
The options exchanges are being pursued by regulators concerned with possible monopolies on the one hand and upstart competitors on the other. Because of the pressure, the most popular stock options now trade on several exchanges at once, a radical change from the one-exchange-per-option practice of the past, while exchanges have cut their fees to almost nothing to battle the big brokerage firms that are handling ever-larger orders.

And this morning, the landscape changes yet again, with the launch of the all-electronic **International Securities Exchange**, the first new U.S. options exchange in more than 25 years.

It all adds up to the biggest changes for the traditional U.S. options marts, the biggest of which is the **Chicago Board Options Exchange**, in their relatively short history. Options, which convey the right but not the obligation to buy or sell shares at particular prices, have been traded in the U.S. on a regulated basis only since the 1970s. For an industry that exploded along with the 1990s bull stock market, now is shaping up as a pivotal time to determine how future investors will hedge their bets on shares.

Options Burst

Total options volume traded at major U.S. exchanges, monthly data, in millions



Source: Options Clearing Corp.

"I think, hands-down, the customers are better off today than they were two years ago," said Gary Katz, senior vice president of ISE. "They're not just trading on one exchange; they're trading on more than one, and that's leading to better pricing."

Specifically, traders, brokers and market chiefs all say the new steps have tight-

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ened "spreads," or the difference between buyers' and sellers' offers. According to Options Clearing Corp., which guarantees every on-floor options trade, that has led to a 60% jump in volume so far this year at the country's four major options markets: the CBOE, the **American Stock Exchange** (owned by the National Association of Securities Dealers), the **Philadelphia Stock Exchange** and the **Pacific Exchange**.

But how much longer can the current cost-cutting by the exchanges and brokerage firms last? Smaller options-trading firms already fear they may be choked out of the market by big players snatching up orders. The exchanges' virtual moratorium on fees, designed to protect their franchises from one another and ISE, will cut off a major revenue stream if it lasts over the long term.

Options quotes appear on page B12.

For most options-trading firms, the changes in the industry have been a mixed blessing. To attract business from brokerage firms, dealers have been forced to offer better prices. Combined with tighter spreads, that means the risk of trading has increased, because there's less room for error and less room for profit.

Many dealers said they are now willing to fill almost any order that is sent to them, regardless of the size, to curry favor with brokerage firms.

In such an environment, many people expect that the largest options trading firms, such as **Susquehanna Investment Group**; **Spear, Leeds & Kellogg**; and the options trading unit of **Knight Trading Group** Inc. (formerly Knight/Trimark) will get even bigger by acquiring smaller trading firms.

The catalyst for the increased competition was litigation and regulators' attention. The Justice Department has been investigating the traditional single-listings system for possible anticompetitive violations, and Securities and Exchange Commission Chairman Arthur Levitt has been nudging the exchanges for years to link their quotation systems so customers know exactly where the best prices are.

Earlier this month, the Pacific exchange and the Philadelphia exchange settled, for a combined $7.3 million, a class-action lawsuit by investors accusing the exchanges of squelching competition. The other markets—along with the **New York Stock Exchange**, which abandoned its options business in 1997—are still litigating the matter.

Michael Schwartz, chief options strategist for CIBC Oppenheimer, said he also thinks the launch of ISE led the traditional exchanges to get leaner and compete. Among its largest contracts at first will be Alcoa, LSI Logic and SBC Communications, not exactly the major technology names that the traditional markets are clamoring after. But the potential of this new electronic rival is clear.

Exchanges have "always been in a battle for volume, even when everything wasn't multiple-listed," said Mr. Schwartz. "This just brings it to another level."

Exchanges essentially make their money as middlemen, charging trading fees; but because exchanges fear the threat of potentially middleman-less electronic competitors, these fee structures are crumbling. For example, the CBOE eliminated all of its customer fees on stock options a month ago today, including a nine-cent transaction fee, a five-cent trade match fee and a three-cent floor brokerage fee.

Another development that came shortly after the exchanges lost exclusive trading rights on many blue-chip options was when firms started paying customers for their order flow. Some small firms have complained that that may ultimately prove to be another blow to their business.

To attract orders from brokerage firms, at least one of the largest options firms, Susquehanna, has decided to buy orders and guarantee that it will execute the order at the best price in the market, all of which puts additional pressure on independent trading firms.

"To compete in the market today to get order flow you've got to buy it and I can't buy it against Susquehanna," said Andy Schwarz, a partner in AGS Specialists Partners at the American exchange. "They can afford to pay more than I do. If they pay 10 cents a contract and I pay 10 cents a contract, they can afford to pay $50,000 a week to a firm and my 10 cents a contract comes out to $500 a week."

A Susquehanna official, however, scoffed at the idea that payment-for-order flow could ultimately drive small firms out of business, thereby allowing larger firms to widen spreads again and erasing the benefits multiple listing has created since CBOE first offered competitors' products in August 1999.

"People that are routing us order flow are not routing us orders because we pay them," the Susquehanna official said. "They're routing us orders because we are offering them the best execution." HA!

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