Editorial

Relying on the "Rules of the Game" in the U.S. Options Market

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Over the past decade, the U.S. options market has moved almost entirely to an electronic trading environment, following the electronic migration that was already well underway internationally. In May 2000, the International Securities Exchange (ISE) introduced the first all-electronic options exchange in the U.S. Shortly thereafter, the existing floor-based markets followed suit and many introduced a hybrid market model that offers a choice of electronic order execution or manual, floor-based trading. In recent years, scalable technology infrastructure and highly portable trading architectures have spurred the proliferation of even more electronic options exchanges in the U.S. The three most recent entrants – Nasdaq Options Market (NOM), BATS Options, and the Chicago Board Options Exchange's C2 – are all offshoots made possible in part due to the existing technology platforms of their parent companies. As other exchanges replicate this multi-platform model and technology further decreases the barriers to new entrants, this proliferation will continue. With nine U.S. options exchanges and counting, there are no signals that the race to launch new markets will abate.

With fragmentation of the U.S. options market has come intense competition. In a competitive electronic environment, order flow shifts rapidly among different markets in response to factors such as exchange fees, trading functionality, and technology latency. The Securities and Exchange Commission (SEC), which regulates the U.S. options and equities markets, has rules in place for a National Market System that mandates electronic linkages among trading venues. Through the electronic linkage framework, options exchanges must effectively route orders to execute against the National Best Bid or Offer (NBBO), ensuring that customers receive the best available price in the market. A similar structure exists among the U.S. equities markets.

Market fragmentation and the structure of the National Market System have come under intense scrutiny following the "Flash Crash" that occurred on May 6th, 2010. Analysts have honed in on three factors that may have contributed to the sudden crash and recovery that the financial markets experienced that afternoon: the speed of electronic trading, the rapid pace at which orders can flow from one trading venue to the next, and the liquidity providers' ability to jump in and out of the market in fractions of a second. However, I would argue that execution speed, automated order routing, and the absence of obligations for electronic liquidity providers are red herrings. Impeding the role that technology plays in the markets would have lasting deleterious effects, and significantly would create a false sense of security. In addition, obligations have never worked historically since market making firms are not willing to catch a falling knife by its point. The consequences of not fulfilling obligations are always small relative to putting the firm out of business.

Keeping this background in mind, it is informative to contrast the market structure of the U.S. options markets with that of the U.S. equities markets and to compare how each performed on May 6th. The options exchanges have largely uniform rules and adhere to the same standards for halting trading in a product. Each exchange also has full transparency around when potentially erroneous trades can be reviewed and broken. The rules in the options market were consistently applied, and as a result of this level playing field, the options markets performed extremely well during that very volatile day. As the joint report published by the SEC and Commodities Futures Trading Commission on the events of May 6th states, "In general, the options markets and participants reported that trading in options did not experience similar disruptions as in the underlying securities markets."

The real lesson we learned on May 6th is that market fragmentation, intense competition, and high-speed electronic linkages can all exist in a healthy environment like the U.S. options market as long as there is a level playing field. Exchanges and alternative trading facilities need to operate under a consistent set of rules that support and promote investor confidence. A product cannot be paused on one venue while orders continue to execute on another. A stock cannot be in "go slow" mode on one exchange while it is trading in microseconds on another. Competition to differentiate our marketplaces, or to gain a technological edge, cannot get in the way of the long-term health and growth of the industry. When investors believe markets are fair and orderly, confidence rises and is the catalyst for future expansion.

Over the past decade, the rapid growth of exchange-traded products fostered a widely held belief that liquidity is guaranteed. On May 6th, that assumption was directly challenged and proven false. In times of stress, liquidity can be mobile and fleeting – and it is by no means guaranteed. To create a market environment that promotes and preserves liquidity in all market conditions, regulators must champion the principles of market transparency, consistency, and neutrality. The "rules of the game" must be well established and consistently applied across trading venues. With this framework in place, the U.S. options markets fared well during the plunge of May 6th. Without it, we saw firsthand how quickly the markets can capsize.