



New Options for Options

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How brokers can harness the complexities of the US options markets and satisfy expanding client demands

By Chris Kelley, Director of Product Management at Fidessa

The dramatic growth in institutional demand for trading US listed options offers sell-side brokers a significant opportunity to provide new, high-value services to their buy-side customers. The recent evolution of the cash equities markets provides some clues as to how the options needs of the buy-side will take shape, but brokers looking to succeed in this area must also account for the particular demands of the options markets.

It's no secret that volumes in listed options remain on a strong upward trajectory, and the activities of institutional investors account for an increasingly large share of that growth. Fund managers that have traditionally held long-only equity portfolios are turning to options as a way to enhance returns and manage risk in their portfolios. As their needs in this area grow, these buy-sides will demand a higher level of service from their options brokers, along with more seamlessly integrated services across the equity and option asset classes. Brokers able to offer this level of service will be well positioned both to secure new options business from institutional clients and to preserve, or even grow, their existing equities volumes with those clients.

The Cash Equities Parallel

Those who have been watching

changes to the cash equities market structure in recent years might feel a distinct sense of déjà vu when looking at current trends in listed options. Market fragmentation, penny pricing, the introduction of Intermarket Sweep orders and the spectre of increased regulatory scrutiny, are all areas where the cash market's recent past offers important lessons about the current direction of the options market, and the tools brokers need for an efficient, scalable business that meets the growing demands of the buy-side.

The overall volume of the options market continues to grow, but that growth is amplified further by the effects of the transition to penny pricing. Begun in 2007, the penny pilot reduced quoting increments in selected option securities from five or ten cents to one cent. The scope of the pilot has steadily increased and experts now estimate that more than two out of every three options trades are in penny-denominated instruments. The results of this fundamental change have been manifold: bid/offer spreads have narrowed dramatically, NBBO quote sizes are radically reduced and liquidity has scattered to a wider range of trading venues.

The decline in bid/offer spreads has decisively changed the economics of the options trading business – payment for order flow is all but non-existent for penny-priced options. To cope with the compressed per-trade revenues, brokers must find ways to increase their execution volumes without a corresponding increase in costs.

The decimalization of the cash equities market offers a helpful lesson, where early adopters of automation solutions were able to meet the challenge of reduced

per-trade revenue and keep their businesses profitable. Sophisticated order management workflow solutions, seamlessly integrated market-access applications and electronic interfaces to buy-side participants all allowed firms to operate more efficiently on a larger scale.

The increasing fragmentation of the options markets, and the accompanying decrease in displayed liquidity, have parallels in the cash market too; these changes also come with their own imperatives for sell-side brokers. To continue to offer high execution quality, brokers have turned to smart routing solutions that allow them to root out the most attractive liquidity, displayed or undisplayed, wherever it resides.

The recent introduction of Intermarket Sweep orders (ISOs) in the options market only serves to reinforce this parallel. Without the ISO order type, smart routers are bound by the options market's trade through rule, limiting the routers' ability to simultaneously access multiple markets at multiple price levels – a significant constraint when price levels are separated only by a penny. With this restriction now lifted, smart routing for options will quickly become a must-have execution strategy for orders of all sizes.

Lastly, many market observers feel that regulation of the options markets will come increasingly into line with that of the cash markets. In particular, the emergence of an OATS-style audit requirement seems probable – and even if regulators don't mandate this, increasingly influential audit and compliance staff at many firms are pressing for similar information to be recorded for internal purposes. Brokers who



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experienced the OATS implementation for equities know well what this would signal: an effective regulatory mandate for the implementation of electronic order handling solutions.

Customer-driven Complexity

Although the lessons from the cash equities markets are compelling, the options markets also offer some challenges that are entirely their own. Brokers looking to win buy-side business in options must also be prepared to rise to these challenges.

The most conspicuous among them is the prevalence of complex orders in the options world. These orders contain multiple legs, all of which are expected to be executed in perfect proportion. To further complicate matters, one of the legs may be an order for the underlying cash equity security.

Complex orders are a growing trend and they bring with them their own set of demands: brokers must be able to accept and record these orders, both verbally and via FIX, with the legs appropriately linked. They must also be able to pass these orders on to floor brokers and to an increasing array of electronic destinations that accept complex orders. Brokers wanting to offer the highest level of service to buy-sides may also choose to invest in complex order algorithms that allow the legs to be worked individually on distinct markets for optimal execution quality, while still minimizing legging risk.

The options markets also have their own unique imperatives with respect to clearing workflows. The clearing window is shorter than for cash (options trades clear T+1), and CMTA arrangements – whereby a trade is ultimately cleared with a broker other

than the executing broker – are commonplace. Buy-side firms' widespread adoption of multi-prime brokerage arrangements adds more complexity; under these arrangements a single trade may be divided among multiple clearing brokers (and the buy-side's allocation across clearing brokers will vary from one order to the next). Furthermore, these multi-prime arrangements are used for complex orders as well, such that a four-legged order divided among three different clearing brokers results in no fewer than twelve separate clearing pieces.

Because of these intricacies, the options market has historically been tolerant of clearing errors, and labour-intensive manual corrections on T+1. This is becoming insupportable, though, as per-trade margins shrink and buy-sides begin to demand a higher level of service. To stay competitive, brokers must invest in more automated, scalable solutions to capture clearing information when an order is received, and persist it onto the resulting trades, and ultimately to clearing systems.

Seizing the Moment

With ever more buy-sides embracing options as a valuable tool for managing their portfolios, the time is ripe for savvy brokers to establish a firm foothold in this growing area. To do this, brokers must combine an awareness of the history of the cash markets, an appreciation of the singularities of the options markets today, and an appetite for meeting the growing demands of their buy-side clients across both of these asset classes. ■

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Fidessa's products and services are built on the simple vision of making it easier to buy, sell and own financial assets of all types on a global basis.

Headquartered in London and with regional operations across North America, Europe, Asia and the Middle East, Fidessa supports 25,000 users across 850 clients, serving a broad spectrum of customers from major investment banks and asset managers through to specialist niche brokers and hedge funds.

Fidessa group is listed on the London Stock Exchange, has a turnover of \$380m and employs 1,500 people globally.

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Key features:

- Trade equities & US listed options from a single platform
- Integrated equity & US listed options market data, news, charts and fundamentals
- Low latency connectivity to DMA, algorithmic, program, pairs, care and smart order execution destinations
- Execution benchmarks, pre-trade, real-time and post-trade analytics as well as integration with broker analytics
- SaaS execution management solution

