Brokers Applaud SEC Approval of ISE's New Order Type for Clean Crosses

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The Securities and Exchange Commission's decision to approve a new order type at the International Securities Exchange could open a new era of institutional options trading.

In February, the SEC brushed aside complaints from competing exchanges and market makers and permitted the all-electronic ISE to offer "clean" crosses for so-called delta neutral trades. These are trades whose executions are dependent on executions of a related stock order.

The "qualified contingent cross" (QCC) will let brokers cross jumbo-size delta neutral orders without exposing the trades to other exchange members. The clean cross eliminates the risk that the order will be broken up. Now most of these trades are taken to exchange floors where the rules require the order be exposed to all floor members, which introduces the risk of a breakup.

Under the new rule, the trade must be for at least 1,000 contracts, execute within the market's best bid and offer and be contingent on the execution of a related stock hedge.

"This is going to make my job easier," said David Beth, co-founder and chief operating officer of WallachBeth Capital, which acts as both an interdealer broker and agency broker for the buyside. "Once I get the right price, I can put it up on the tape and move on to the next trade."

By barring other exchange members from participating in the trade, the ISE makes it painless for brokers to cross large prearranged trades. And because the ISE is a 100 percent electronic exchange, the process is likely to be faster and cheaper than consummating the trade on an exchange floor.

"With QCC, market participants can execute large, complex transactions more efficiently," said Boris Ilyevsky, managing director of ISE's options exchange. "This order type reduces fees that otherwise may have been paid to an intermediary, and allows traders to execute these sophisticated trades quickly and easily. The faster they can put up a trade, the faster they can make that next phone call or type out that next IM to solicit the next deal."

According to Tabb Group, at least a quarter of industry volume is done in trades of at least 1,000 contracts. According to industry sources, about 75 percent of all crosses are tied-to-stock trades. The remainder are options-only crosses, also known as "outrights."

Interdealer brokers do most of the tied-to-stock trades on behalf of large institutional brokerages such as Goldman Sachs. To find the other side of the trade, an IDB taps into a network of liquidity providers, often known as "vol" traders.

In this market, communication is done through instant messaging and price discovery is done on analytics programs such as on SunGard's Valdi Options Solutions--formerly MicroHedge. This approach is said to rankle the SEC, which prefers exchange-based price discovery. Vol traders include large firms as well as lesser-known player such as HAP Capital and First New York Securities.

Top IDBs include WallachBeth, Linkbrokers, Tradition Financial Services, Tullett Prebon, GFI Securities and BGC Financial.

The ISE spent nearly two years trying to win SEC approval for its clean cross, against strong opposition from other exchanges and market makers. It claimed it needed the order type to compete effectively against floor-based exchanges.

The ISE's detractors argued that order exposure was a hallmark of the options industry and that the QCC was in violation of that tenet.

For its part, the ISE argued there was little competition on exchange floors because electronic trading and penny increments have taken many traders off the floors in recent years. Also, exchange rules do not permit their off-board members to participate in floor trades. So, in practice, exposure on floors is nonexistent, the ISE asserted, and its QCC does not represent radical change.

SEC data belies that argument. A study undertaken by the regulator last year showed that about three-quarters of all trades of more than 500 contracts at the Chicago Board Options Exchange were broken up. Another 71 percent of all large trades at the Nasdaq PHLX were broken up.

IDBs whom Traders Magazine spoke with confirmed that the risk of breakup on exchange floors was very real. They welcome the new QCC order. "This is not just good news for IDBs," said one senior IDB official. "It's good news for the wholesale markets. It's good news for the market makers. It's good news for anybody who depends on the delta neutral options-versus-stock package. QCC is all about putting together a delta neutral package and not having it get broken up."

A common complaint is that floor traders will often step in at the last minute and break up a trade. NYSE Arca tried to end that practice last year when it proposed a requirement that its floor traders make a "final bid" early in the process. That proposal was derialed by complaints from market makers.

Some believe the new rule will hasten the demise of the exchange floor. "There are some big players that want to create a live and tied exchange," said Mike Menslage, a vice president at trade processor Rickard & Winans, and a former CBOE specialist. "The ISE has its regular exchange where you can point and click and buy options at the national best bid and offer. But an institution could have this separate exchange, where it can see the same quotes but they are tied to stock."

That transparency could cause the market for delta neutral trades to explode, Menslage said. "You would be able to access the option and the stock right on the screen," he said. "The concept of trading volatility as an asset class can be done electronically."

To do so, the ISE would need to build out functionality found at the OneChicago single-stock futures exchange, traders say.

With the exchange's BETS system, traders can simultaneously input both the futures portion and the stock portion of a combined trade. The futures trade goes to OneChicago's matching engine. The stock trade is reported to the Nasdaq trade reporting facility.

The ISE is considering something similar, a spokesperson said.

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