

The Stock Part of Option Trading

Many stock exchanges compete for the same stock flow, but the CBOE Stock Exchange operates in a niche with little competition. Addressing the specific needs and problems of the option traders, the CBSX is focused on providing low-cost and efficient direct access to stockmarkets for the trader who mainly use stocks for hedging. The relationship with the largest U.S. option exchange definitely helps in this respect

Q: What are the philosophy and the competitive advantage of the CBOE Stock Exchange?

A: The CBOE Stock Exchange, or CBSX, is part of the U.S. largest options exchange, the Chicago Board Options Exchange, or CBOE. While we are a separate company that focuses on stock trading, the CBOE is the largest owner, and that relationship has been very important for our development.

Our philosophy is based on reducing trading costs and increasing trading efficiencies for the multi-asset class trader, most specifically, the options trader. We spend our time identifying and seeking solutions for the problems of the option trader, such as the costs and the efficiency of trading. As an exchange, we offer solutions for these problems.

Option traders need to hedge their positions, and they often use stocks for hedging. In addition, they do a lot of option transactions that have a stock-like component. The CBSX represents the stock part of the option trading. Its creation as part of the CBOE group has resulted in a big change for the CBOE member.

Previously, many of the CBOE traders needed a broker to represent them on stock exchanges, while now, for the first time, they have right to trade directly on a stock exchange. Through CBSX, they also have access to all the other stock exchanges in the United States through very fast connections.

Overall, the niche where we add value is providing access to the stock market for the option trader and, specifically, the CBOE member option trader. If we were a stand-alone stock exchange, we would be joining a very crowded market. There are eight other stock exchanges competing for executing stock flow. The revenues associated with transaction execution have narrowed greatly, in some cases down to zero, so it is critical to be able to operate in a niche market.

Q: How many members does the CBSX have? What kind of liquidity those members generate to make your strategy viable?

A: I believe that there are over 100 member firms. We get liquidity from multiple sources, including dedicated liquidity providers on CBSX and any other firm



DAVID HARRIS is the President and Chief Executive Officer of the CBOE Stock Exchange (CBSX).

Before CBSX, Harris served as The American Stock Exchange's Senior Vice President of Business Planning and Strategy where he was responsible for developing, planning, and implementing critical aspects of the Exchange's strategic direction, including forming new business lines, developing strategic relationships with other markets, and formulating market structure, as well as providing guidance regarding business development and other initiatives of importance to the AMEX and its customers, and execution of aspects of the exchange's new trading technology initiatives.

Prior to joining the AMEX, Harris served as Executive Vice President and General Counsel of Nasdaq Liffe Markets LLC (NQLX), formerly a joint venture between The Nasdaq Stock Market Inc. and the London Financial Futures and Options Exchange. He was a founder of NQLX and played a vital role in planning, directing, and executing the exchange's successful launch and subsequent operation. Harris also served as Counsel to Chairman and Chief Executive Officer of the NASD and Nasdaq.

Earlier in his career, Harris served as a Senior Associate at Kirkpatrick & Lockhart and as Senior Counsel in the Division of Enforcement at the Securities and Exchange Commission (SEC).

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that provides limit orders. We add value to liquidity providers by aggregating on an exchange a unique stream of order flow – hedging order flow. Previously, most of our option traders had to pay a stock execution fee for their hedging activity. Now, for the first time, we offer the opportunity to come into our market directly and to pay them for providing liquidity. The cost reduction to the options trader is very significant. We have found that many traders are completely unaware that they could earn money providing liquidity, and we educate them in this respect. There’s a difference between being paid 26 cents per hundred shares when you provide liquidity and being charged 50 cents per hundred shares through a broker. That is a huge cost saving.

Q: What is the size of the exchange in terms of listed stocks and daily volume?

A: We have about 2,800 listed stocks, which are the most actively traded securities in the U.S. exchanges. Our objective is to make sure that we have an underlying security for every option class that the CBOE trades. Every time the CBOE adds a new option class or a new name, CBSX adds the name along with it. The daily volume is about 5 million shares a day on those 2,800 names.

Q: What’s your strategy for firms of individuals who are not members of the CBOE? Can they become members of the CBSX?

A: Yes, we have a permit program, which is very similar to the permit programs on ECN. You have to fill out an application and it is free to become a permit holder or a member of CBSX. The only cost is a one-time application fee of less than \$500 that covers CBSX’s administrative expenses to do a background check. So it is very easy to become a CBSX member if you’re not a CBOE member. If you’re a CBOE member, you’re automatically a member of the CBSX.

Our strategy is to have almost no barriers to entry and no ongoing costs. If you compare our price list with the fee structures of other exchanges, you will see that the other exchanges usually have many hidden expenses (like monthly membership fees and connectivity charges) associated with trading. At the same time, we don’t have any monthly or annual membership fees. We don’t charge people to connect to us and we don’t have port charges. It’s very straightforward - we’re a new market and we want as many people in to trade as possible.

Q: Do you also provide market data to your members, like the NYSE and NASDAQ do?

A: Our members can get the full depth of the data for free. We have a very flat and open market structure for everyone on our market. Although we have dedicated liquidity providers, they don’t have any advantage over the other participants. All the participants see the same information at the same time. The model of Archipelago has been very successful and we’re replicating it.

Q: Forward-looking, do you envision the possibility to compete for new listings with the NYSE or the NASDAQ?

A: Not really, at least not in the near term, because it takes a lot of support infrastructure. The competition to get a new listing is fierce, and there’s a regulatory burden attached to running a listings business. We are very focused on remaining a low-cost operating platform, and even with our small volumes, we are above the break-even point, so we don’t want anything to jeopardize our low operating costs.

Q: What are the unique features of your operating platform that make it attractive from the technology perspective?

A: One of the unique features, at least in the U.S., is the CBOEDirect matching engine. It is an independent matching engine, which supports the options ex-

change on CBOE and the stock market on CBSX. It also supports two separate future exchanges.

I believe that represents a critical competitive advantage of CBSX over its rivals in the U.S. Considering that CBSX was simply an idea in August 2006, we managed to bring a national stock market online in a matter of several months, by March 2007. CBSX was launched with 12 products, and within 9 weeks, we had our full planned offering of 2,800 products up. I believe that this achievement is a testament to the excellence of the CBOE staff and CBOE technology.

We are currently waiting for regulatory approval for electronic buy write packages, or a stock and an option package tied together. That will allow market participants to send single orders that have multi-product components. The option side gets optioned for price improvement, and the stock part, which gets priced as part of the option process, gets printed on CBSX. That is a multi-product offering that is serviced by an asset independent trading platform and is executed in a single regulatory entity. I believe that offering is unique in the United States.

The matching system is a very robust and a very fast system. The execution speed is in the range of 2 milliseconds. Our order capacity is growing almost every month and we are able to support about 18,000 orders per second. It is a fully scalable platform, so if CBSX decides to invest in increasing the capacity, it's easily attainable. Our technology team is great and it seems that every time we increase the capacity, we reduce the execution time as a by-product.

We don't plan any more investments in increasing the execution speed for the time being because most of our customers are very happy with the speed. It all comes back to the fact that, when you're a new market, you must maintain a very low cost structure because good markets always take time

to develop. The point is that it is critical to build your market to meet the needs of the users, and not run out of money in the meantime. That's why it was so important for us to reach the break-even point at low volumes. That gives us the luxury of focusing on developing a lasting business as opposed to dealing with short-term problems.


Q: Having in mind the volatility of the markets, does your system have the capacity to handle periods with high volumes?

A: Yes. We haven't used more than 20% of our total matching capacity at any given time, even with the volatilities in August. We are fully utilizing the economies of scale of the CBOE. Even on low volumes, we have a viable business model. We are really focused on developing a market that caters to our niche, leveraging both the staff and the technology of the CBOE to build a sustainable business model on the stock side.

If we were an independent startup exchange, it would be much more difficult because it is still a game of economies of scale. The CBOE has achieved economies of scales on the options side, so it is logical to extend to additional products, such as futures and stocks.

Q: Do you plan to expand your strategy towards the futures traders as well?

A: Yes. We do talk with futures exchanges about offerings that would make sense for the futures trader that utilize stock as part of the transaction. But our focus remains servicing the options traders.

We have the advantage that no one may focus on the option traders like CBSX. Also, I'm able to go to the floor of the CBOE and talk to our customers every day. Our competitors in the U.S. don't have the same advantage in servicing this niche. Our users have very easy physical access to us, which is also important. If they have a problem, they know how to reach us. There's a good communication flow that helps on both sides. 

CBSXSM

CBOE STOCK EXCHANGE

Website	www.cbsx.com
Address	Chicago Board Options Exchange 400 South LaSalle Street Chicago, IL 60605
Tel. No.	312-786-5600
Inception	03/05/2007

CBSX INFORMATION	
Trading Sessions	09:30 - 16:00 (EST)
Liquidity Providers	DPMs: 6 / RMMs: 2
Trading Platform	CBOEdirect®

MARKETS & SEGMENTS	
Market Model	Reg-NMS compliant
Issues Listed	Securities, ETFs
Number of Issues Listed	2,884

TRADING STATISTICS	
Volume October 2007*	131.8
Average Daily Volume Oct 07*	5.7

KEY EXECUTIVE	
President & CEO of CBSX	David Harris

*million shares	
Data through: 10/31/07	
Source: CBSX	

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