FINANCIAL INFORMATION FORUM

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May 10, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street N.W.
Washington, D.C. 20549-0609

Subject - Concept Release: Competitive Developments in the Options Markets
Release No. 34-49175; File No. S7-07-04.

Dear Mr. Katz:

The Financial Information Forum (FIF) is pleased to submit comments regarding the referenced concept release. We are especially focused on the issue of penny quoting and trading in options. FIF is a forum which enables, market data vendors, exchanges, utilities, service bureaus and broker dealers to discuss and share information and solutions regarding factors that concern securities information processing in all aspects of the securities industry, from price discovery through clearance and settlement. (www.fif.com).

Background

- Market data traffic for US options markets continues to grow at 100% per year or more
- New market participants using electronic trading platforms and additional autoquoting facilities at floor-based exchanges continue to inflate quote rates
- The quote-to trade ratio for options is rapidly approaching 1,000 to one
- The market data traffic for US options alone exceeds the data traffic rates for all major equity markets worldwide

Our Issue

FIF participants include market data and order routing vendors, which have to display and distribute US options market data traffic. They also include broker/dealers and other market participants that are consumers of this information. The cost of processing, transmitting, displaying and storing US options market data traffic has for several years now exceeded its economic value in the market place. It has for some time been uneconomic to supply these data, except from the standpoint that a full-service market data provider or a supplier with a focus on derivatives has a need to make these data available to their customers. It is therefore already the case that other business is unfairly being asked to subsidize the cost of delivering US options market data.

Should the Commission allow penny pricing in US options, market data rates would be expected to take another quantum leap. This would seriously strain both the delivery systems of market data vendors and the internal networks and distribution infrastructure of market data consumers. Consumers are already looking for solutions that permit them to reduce market data traffic rates to avoid further escalation of market data distribution costs. The drive toward cost reduction will militate against acceptance of such higher update rates. It is therefore likely that consumers will seek to reduce the amount of US options market data traffic with the result that the Commission's overall goal of increased market transparency would actually be negatively impacted.

We urge the Commission to reject movement to penny pricing for US options to avoid a counterproductive increase in market data rates that is likely to reduce overall demand for options market data and consequently reduce market transparency.

Details

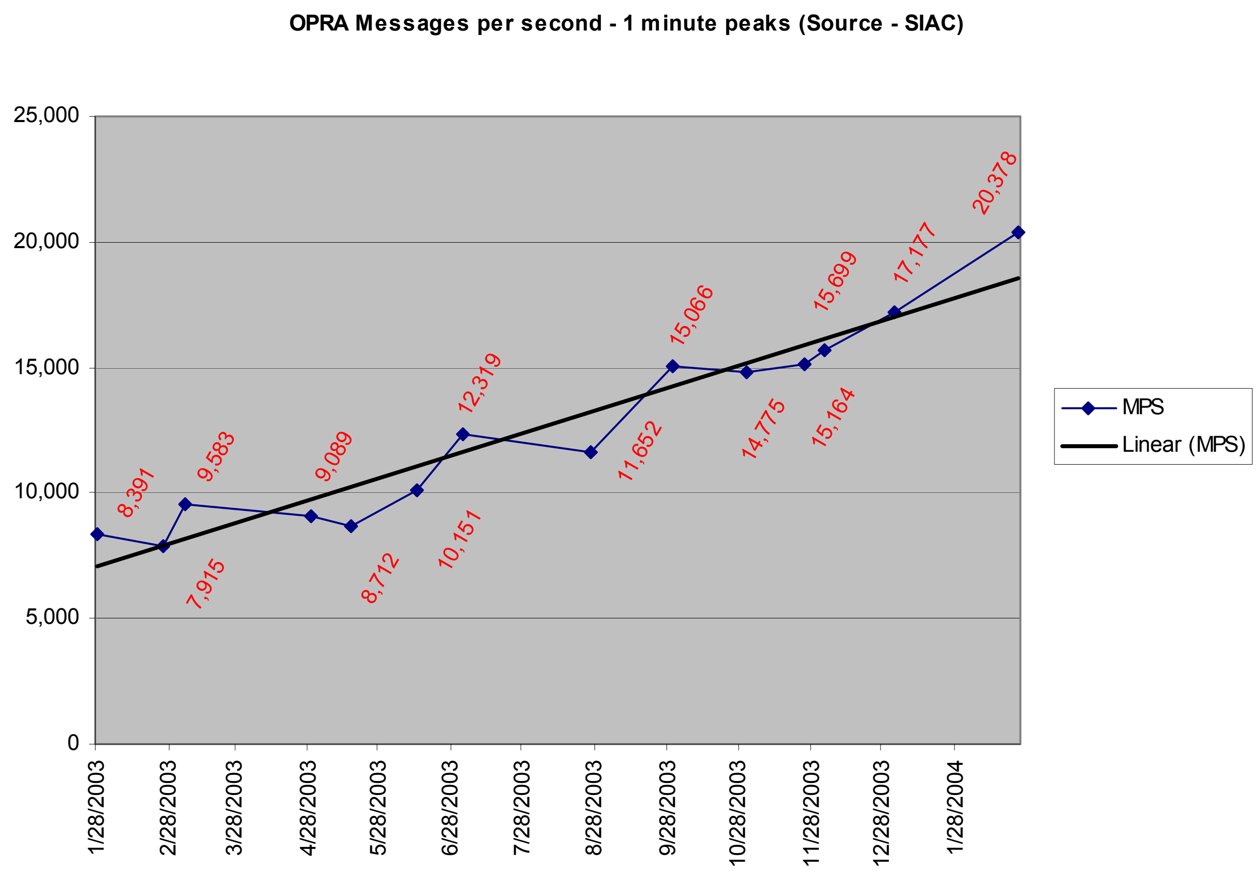
The Concept Release covers a number of significant issues relating to the US options markets. However, the FIF is focusing its comments specifically on questions 38, 39 and 40.

> Question 38. Would a move to penny quoting in the options markets place an undue strain on existing system capacity? If so, which market participants would be most negatively impacted (*e.g.*, broker-dealers, exchanges, vendors)?

The FIF believes a move to penny quoting would place undue strain on existing system capacity. As noted above, options market data traffic continues to grow at an extraordinary pace. The chart below, based on monthly statistics supplied by SIAC, shows that peak message rates for non-foreign currency options rose from 8,391 MPS in January 2003 to 20,378 MPS in February of this year, an increase of 143%. The debut of the Boston Options Exchange (BOX) and anticipated enhancements to quote capabilities from three of the floor-based options exchanges portends a continuation of that trend over the near term. (CBOE has already implemented similar changes and its quote rate increased nearly three-fold as a result.)

In view of that, OPRA recently raised its "throttle" on message rates from 32,000 MPS to 40,000 MPS. It has the capability of expanding to 52,000 MPS if necessary before further infrastructure upgrades are required.

By comparison, Reuters reported at a recent FIF Market Data Capacity meeting that the 'world' peak for market data up to February was 34,800 mps on a 10-second peak basis, January 16. The OPRA peak in February, adjusted to a 10-second peak basis was 21,011 mps. Thus OPRA data alone accounted for more than 60 per cent of peak global market data traffic that day



On a daily basis, roughly $1.2 trillion in foreign currency transactions, nearly $900 billion of treasury and other fixed income transactions and more than $60 billion of equity trading are done. Meanwhile just over $1.6 billion dollars of OPRA option premium business is transacted daily. Figuring the percentages, the dollar value of option premium business daily amounts to about seven tenths of one percent of the global business reported via market data vendor systems. Yet it consumes more than 60 per cent of the global market data resources. We suggest there is something very wrong with this model.

It is clear that the infrastructure costs associated with options market data are far higher per dollar of business transacted than for any other asset class. End-users of these data are well aware of this disparity and are looking for ways of reducing these disproportionate costs.

The early studies on the impact of decimal pricing in the equities and options markets suggested that moving from eighths and sixteenths of a dollar to pennies would more than double quote rates for options. Option quoting currently in dimes and nickels is roughly comparable to the former eighths and sixteenths regime. Allowing penny quoting in options now would likely have a similar impact, that is, to double quote rates from their current levels.

That raises the specter of overwhelming current OPRA infrastructure. But even assuming OPRA would deliver update rates c. 42,000 MPS and rising, that would push global rates to something over 55,000 mps. At that level OPRA's share of global market data traffic would be over 75% of total global traffic with no increase in economic value of the data.

We submit that this does not make economic sense and would force market participants to take even more stringent steps that might work to reduce traffic and thus market transparency, rather than increase it.

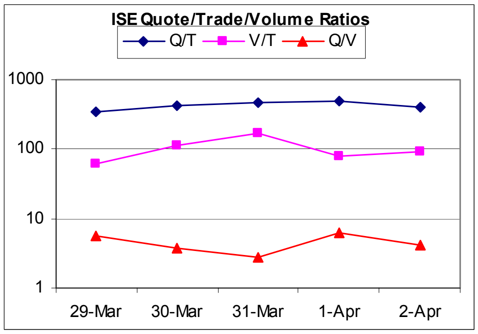
> Question 39. If so, are there ways to alleviate potential strains on system capacity to allow the options markets to begin quoting in penny increments?

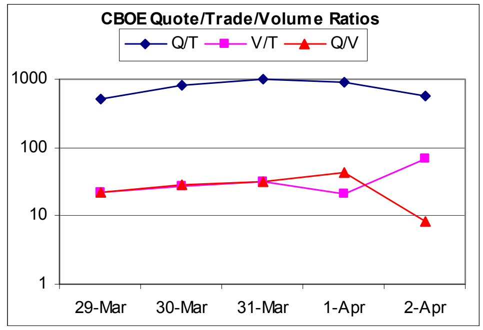
Participants in the FIF do not believe there are any effective means of mitigating options market data traffic growth under the current regulatory structure. It may be necessary to make changes, possibly along the lines of those contemplated under the current Regulation NMS proposal, which would alter the type and quantity of market data required to be distributed.

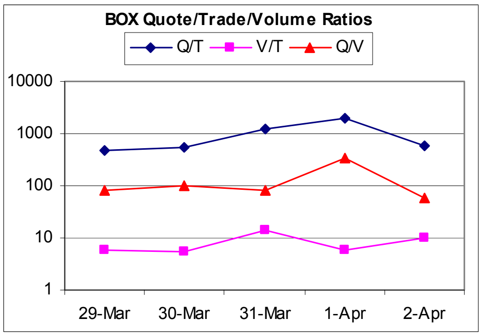
Alternatively, incentives for quoting that improve pricing along with disincentives for quoting that does not improve pricing may tend to restrict traffic growth.

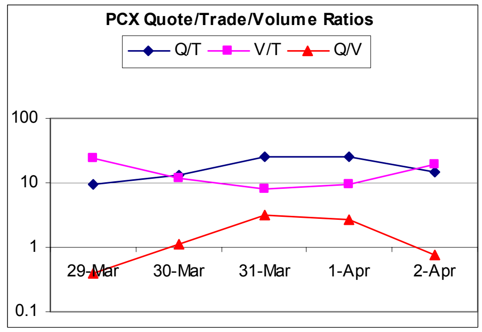
> Question 40. Are there other issues that make a move to penny quoting in the options markets infeasible or inadvisable? For example, what would be the impact on the rapidity of quote changes (*i.e.*, "flickering quotes")?

The phenomenon of quote flickering can be very real. As mentioned earlier, the quote to trade ratio for OPRA equity and index options overall is rapidly approaching 1,000 to one. However, on an individual option class basis, it has already exceeded that for some markets. The graphs below show quote to trade, volume to trade and quote to volume ration for four of the six markets the week of March 29.









It is also clear that there is no correlation between higher quote and either higher volume or additional trades. Thus a regulatory environment that promotes additional quoting as a key means to increase competition, improve transparency and make markets more efficient may be not be achieving its desired goals.

A side effect of higher quote rates is that time must be divided into finer and finer increments to articulate the chronology of events. There is a point at which the level of granularity and synchronization required becomes difficult to maintain given the diffuse nature of the supplier and user community.

At some point in the pace of quoting, differences of a few milliseconds in clocks will result in false information about the chronology of events across multiple systems. We may be nearing an entirely new realm of time synchronization and measurement for which there are no current technical solutions that could reasonably be deployed industry-wide.

Standards for measuring best execution may become difficult to enforce when consistency of time recording and distribution begins to break down.

Our Recommendation

We recommend that the minimum price increment for options quotes and orders remain at the current nickel for options priced up to $3 and 10 cents for options price over $3.

We would urge the Commission to take a broader view of the impact of penny pricing for options and its very real potential to actually reduce availability of market data and transparency in the options markets.

We would also urge the Commission to look to means of promoting competition among markets other than a heavy reliance on increasing quoting by all market participants.

Thank you for your consideration. If you require further information or clarification, please contact the FIF Program Office at (212) 422-8568.

Sincerely,

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