



Options Exchange

AS TRADING VOLUMES CONTINUE TO RISE,
NYSE GROUP IS WELL POSITIONED IN THE OPTIONS MARKET

Embarking on its journey as a for-profit, publicly traded company, NYSE GROUP INC. (NYX) intends to leverage NYSE Arca's presence in U.S. options trading and pursue new opportunities in this fast-growing segment.

The trading of U.S. equity options has increased significantly over the past 10 years, at a compound annual growth rate of 22.9 percent from 1995 to 2005. In fact, volume growth in the options market since 2003 has outstripped that of the overall U.S. equity market, according to the Options Clearing Corp. (OCC). Last year, for example, OCC says average daily contract volumes increased by 27.3 percent, compared with 5.5 percent growth in equity trading volume. This year, options trading volumes continue to set records. A new monthly volume record of 199.7 million contracts was achieved in May. This represents an 82 percent increase over May 2005 and a 12 percent increase over the previous monthly volume record, set in January 2006.

Various factors — including the rise in electronic trading, advances in technology and lower transaction costs (fees and spreads) — have combined to greatly improve the customer trading experience, explains Michael Walinskas, OCC's senior vice president of product and business development and executive director of the Options Industry Council.

Walinskas also points to increased investor awareness and participation, particularly among the institutional investor community. "Institutional customers, including hedge funds, are in-

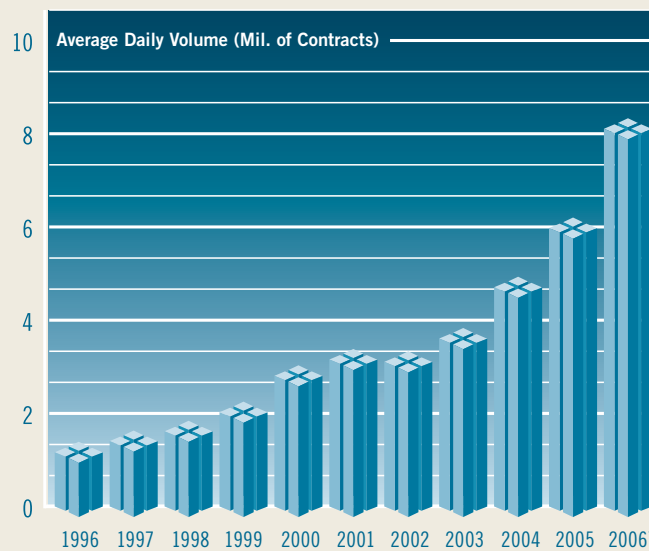
creasingly becoming adept at using the options product as a financial tool to help accomplish their portfolio objectives. These users are especially attracted to the near-instantaneous executions and deep market liquidity afforded by the listed options marketplace," he says.

Matthew Gelber, NYSE Group senior vice president, Derivative Products, notes that a growing group of institutions are taking advantage of the liquidity in options and are structuring portfolios with targeted returns and lower levels of risk and volatility.

"We're seeing the advent of more sophisticated customers using lots of new technologies to access the markets," he says. "As the tools have gotten more sophisticated and the strategies more complicated, the need for fully electronic markets that allow buyers and sellers to meet almost instantaneously without intervention has played directly to the NYSE Arca strength. That is what NYSE Arca has built."

THE RISE OF OPTIONS TRADING

Average daily trading volume has more than doubled in the past five years



*Through May 31

SOURCE: THE OPTIONS CLEARING CORP.

RISK MANAGEMENT

While some observers suggest that options can contribute to market volatility, more often they are cited as important tools for risk management. In March, U.S. Federal Reserve Chairman Ben Bernanke stated that derivatives were being well managed and had bolstered the financial system's resilience to shocks in recent years.

"Although no single factor accounts for this favorable performance, derivative instruments undoubtedly have contributed to this resilience because they offer firms means for managing their risks," Bernanke said in response to a written question in connection

BY JEANNE COTRONEO DARROW

with a Feb. 16 Senate Banking Committee hearing on the Fed's semi-annual report on monetary policy.

Gelber explains that upward of 20 percent of the options transactions are complex trades that include multiple asset classes, or stocks and options packaged together. For example, a retail investor might purchase what's called a "buy right," he says, "buying a stock and simultaneously selling options against that stock."

Some corporate issuers use options to execute stock-buyback plans. Typically, buybacks are carried out through a tender offer or on the open market. But a third, increasingly popular alternative is to buy a call or sell a put, explains Philip Gocke, a longtime options industry participant and current consultant to the Options Industry Council.

"Both transactions most likely will give the issuer the opportunity to buy the stock at better than the fair market price," says Gocke. He notes that issuers can even buy an out-of-the-money call and sell an out-of-the-money put to achieve an even stronger impact on the supply of its stock.

THE OPTIONS MARKETS

The New York Stock Exchange's merger with the Archipelago Exchange (now known as NYSE Arca) marked NYSE Group's return to the options business. The NYSE traded options from the late 1970s through 1997, when it sold its options business to the Chicago Board Options Exchange. NYSE Arca's options business was established in September 2005, when it completed its acquisition of the parent company of the Pacific Exchange. Through NYSE Arca, customers can trade more than 175,000 options products. In fact, NYSE Arca trades about 500,000 contracts each day on more than 1,700 stocks.



OPTIONS DEFINED

A stock option allows investors to fix, for a specific period of time, the price at which 100 shares of stock can be purchased or sold for a premium, which is a percentage of what an investor would pay to own the stock outright. That leverage means that by using options, investors might be able to increase their potential benefit from a stock's price movements.

For example, it costs \$5,000 to own 100 shares of a \$50 stock, while it might cost \$500 to own a \$5 call option that would give you the right to buy 100 shares of the same stock at the strike price of \$50 at any time during the life of the option. Assuming that a month after the option was purchased the stock price rises to \$55, the investor earns \$500, or 10 percent, on his equity investment. However, for the same \$5 increase in the stock price, the call-option premium might increase to \$7, for a return of \$200, or 40 percent.

"Options can be used as part of a successful strategy in an up market, a down market or even a sideways market — that's something unique to options," Walinskas points out. Adds Gelber: "At the end of the day, options are most frequently used as an insurance product to remove market risk in owning or trading in an individual security or market segment."

SOURCE: THE OPTIONS CLEARING CORP.

NYSE Arca, which has about a 10 percent share of the options market, is one of six U.S. equity options exchanges that currently compete for order flow. All of the traditional floor-based exchanges have adopted hybrid models, incorporating greater electronic trading capabilities to complement floor trading and improve access for market participants. The SEC regulates the industry, and options exchanges, under the Options Intermarket Linkage Plan and self-regulatory organization (SRO) rules, must avoid executing trades at prices inferior to the best available price.

As a way of narrowing spreads between buyers and sellers and thus reducing transaction costs and the practice of brokers and markets paying for order flow, NYSE Arca recently announced plans for a pilot program to quote and trade listed options in certain exchange-traded funds in penny increments, instead of the current 5¢ or 10¢ increments, subject to SEC approval.

NEW OPTIONS PLATFORM

This summer, following SEC approval of a rule filing filed with the SEC in May 2006, NYSE Arca expects to introduce a faster and more flexible options trading platform based on the architecture of its existing equities platform.

"Our new platform will service the options industry in a way that's

never been done before," says Gelber. "We're going to provide additional capacity to the business unlike anything that exists today. Bringing together the stock and options trading on a single platform will allow us to do things faster and potentially more efficiently than anyone else in the space." ▢