

# Traders Magazine

## Benchmark Trades in Options?

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Benchmark trades may be coming to the options market. 3D Markets, a company formed last year to develop block equity options products, plans to work with an exchange to introduce institution-oriented benchmark trades.

Any exchange that partners with 3D Markets will need to get Securities and Exchange Commission approval for the order type. It will also have to petition the regulator for an exemption to the Options Market Linkage Plan's trade-through rule.

"We began talking informally with the SEC about this in November," said Jeromee Johnson, president of 3D Markets. In December, 3D, based in New Hope, Pa., acquired a broker-dealer, through which it plans to arrange institutional options trades.

Benchmark trades are currently allowed in equities, but not in the listed options market. A benchmark trade is a transaction executed at a reference price that's not related to the quoted price of the option at the time of the trade. An example in equities is a volume-weighted-average-price trade. The SEC has OK'd exceptions for certain benchmark trades to its trade-through rule in equities.

"In Regulation NMS, the SEC says when you forward-price a trade, like with VWAP, you don't have to honor the national best bid and offer. You can print outside the inside and report it to the exchange," Johnson said. "For our gamma-weighted-average-price trades and benchmarks in general, if they're acceptable benchmarks for equity options, they should fall into a similar rule set. That's not there today under existing regulations."

3D Markets has created a benchmark that purports to measure options execution quality for large institutional trades. Called Gamma-SPT, for gamma-synthesized parity trade, the benchmark incorporates the VWAP of the underlying security and the option's gamma to come up with a measurement tool for execution quality.

Johnson said 3D is talking to at least one exchange about benchmark trades. He declined to say which exchanges could emerge as potential partners.

Edward Tilly, executive vice chairman of the Chicago Board Options Exchange, told Traders Magazine the CBOE "would consider exploring an exemption for benchmark trades if it benefited our customers." The Boston Options Exchange said it is considering the idea of benchmark trades, although it has no immediate plans to move forward on this front.

3D's Johnson noted that the SEC could grant an exchange an exemption from the trade-through rules specified in the Options Intermarket Linkage Plan and approve related exchange rule filings allowing benchmark trades. He said benchmark-trade auctions could take place, at least initially, before the market opens, with their executions printing after the market closes. Johnson said it might not be necessary for the Options Intermarket Linkage Plan to provide an exception to its trade-through rule for benchmark trades if the trades are entered before market hours.

Johnson said an exchange could theoretically ask to execute benchmark trades under Form PILOT, which enables exchanges to launch new products on a pilot basis without going through a public comment period. However, he said, the SEC would probably put the idea out for comment. In that case, "realistically, this could be a six-to-nine-month-plus timeframe," Johnson added.

If 3D's plan works, the firm is likely to enter into an exclusive license with at least one exchange for the use of its execution benchmark as the basis for a full-day crossing product, according to Johnson. The crossing system, which would use Archangel, 3D's trading platform, would probably be run as a facility of the exchange, Johnson said. 3D also plans to provide transaction-cost analysis to customers using Gamma-SPT as an execution benchmark.

To date, there has been no real need for such a benchmark. However, the growth of institutional options trading coupled with smaller depth at the inside market, particularly for options quoted in pennies, means that large orders are likely to be executed over a longer period of time. That could make an execution benchmark a useful trading tool.

-Nina Mehta