

## EQUITY OPTIONS SPECIALISTS: TOO MUCH OF A GOOD THING?

Specialists play a critical liquidity provisioning role in equity options markets. However, the advantages specialists receive for taking on this role are often disproportionate to the liquidity they provide. Lack of competition, special allocation rights for small orders and a murky appointment process are too high a price to pay for extra liquidity in already liquid symbols.

Since 2006, the number of equity option exchanges in the US has grown from 5 to 16. With this growth came an exponential increase in the number of specialist<sup>1</sup> appointments to the underlying symbols now listed across multiple exchanges.

Eleven of these exchanges appoint a single specialist per underlying option symbol that is responsible for ensuring liquidity is always available. This specialist is subject to higher quoting requirements than other market makers (MMs) in terms of size, width, presence and strikes covered. They are also obligated to help ensure the opening of the appointed symbols.

We support the spirit of these appointments as we believe specialists, in general, fulfill an important liquidity provisioning role, especially in periods of heightened volatility.

However, in the US equity option space, this specialist system creates significant barriers to competition. In our opinion, specialists receive outsized benefits for the services they provide, especially in liquid symbols that may not require additional liquidity. For that reason, we feel that the system should be amended to proportionately reward specialists for the liquidity they provide and to support a transparent and competitive appointment process for these roles.

There is no regulatory limit on the number of specialist appointments a single MM firm can hold in a single symbol across the 11 exchanges that appoint specialists. The practice of holding multiple appointments for the same symbol is, to some extent, prohibited within an exchange group. However, it is not a rule and its application opaque. When coupled with the fact that most retail orders for US equity options are routed through wholesalers who have an affiliated MM and have exchange routing discretion to maximize its interaction rate, the situation develops where a combined wholesaler/MM firm can maximize its internalization to a far larger extent than was intended by the specialist concept.

<sup>1</sup> Exchanges use varying terms for the role of specialist: Lead market maker, primary lead market maker, designated market maker. This paper uses the term "specialist" to refer to these roles.

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There are several key attributes to the specialist appointment in the equity options market structure that we believe impede competition, encourage internalization and discourage maximum price improvement thereby implicitly widening spreads for retail investors.

These attributes are:

- ▲ The small order size allocation rule also known as “the five-lot rule”
- ▲ Perpetual and opaque appointment process for specialist
- ▲ Specialist appointment concentration

## DISPROPORTIONATE REWARDS

### *THE FIVE-LOT RULE IN A MULTI-LIST ENVIRONMENT*

In return for ensuring liquidity is available in the underlying symbols, the appointed specialist receives heightened trade allocation rights from the exchange. The specialist will receive an extra allocation of trades when they are present on the National Best Bid Best Offer (NBBO). For larger marketable orders, the specialist gets a guarantee of at least 40% of the order (up to 50% if only one other MM joins the bid/offer). In addition, any retail non-directed marketable order for five lots or less is entirely allocated to the specialist.

The five-lot rule allows specialists 100% allocation of all retail marketable trades of five lots or less as long as they are present at the NBBO (even if they were the last to join the bid or the offer). We view this feature to be disproportionately beneficial to the specialists. In these situations, they do not need to set the markets or step in with additional liquidity – especially in liquid names – to receive these rewards. They only have to add liquidity to the NBBO, which is often already sufficient.

### *PERPETUAL APPOINTMENT*

Specialists are given perpetual appointments with no mechanism for competitors to challenge them. The specialist’s appointment can only be terminated if they either choose to no longer participate in the role or if the exchange subjectively decides to re-allocate. This means that an incumbent has a permanent structural advantage as long as they continue to do the minimum required to meet their heightened quote obligations and provide liquidity.

The requirements to qualify as a specialist can be distilled into one mandate across exchanges: provide operations that enhance the ability of the exchange to successfully compete for order flow in the underlying symbols the specialist trades. There are also both quantifiable requirements like quoting obligations, opening of symbols and market quality as well as more subjective qualifications such as promotion of the exchange to market participants.

### *OPAQUE APPOINTMENT PROCESS*

The process for appointing specialists is entirely discretionary for the exchanges and is done in perpetuity; this serves to entrench the incumbents, thereby reducing competition. In our opinion the criteria for selection is vague at best. We believe that these appointments are granted based more on a firm's ability to bring order flow to an exchange (via its affiliated wholesalers) than on the quality of the markets it makes and liquidity it provides. This process thus rewards only those with the largest scale who can cover the most instruments and route the greatest volumes to exchanges. The current process, if not changed, will further contribute to the concentration of specialist roles among a limited number of MMs with affiliated wholesalers.

### *SPECIALIST CONCENTRATION*

Connecting to a market structure this fragmented has created its own set of issues and hurdles for all market participants. Beyond the complex economics this ecosystem contributes, it also allows the ability of MMs to have more than one specialist appointment in a single underlying symbol across exchanges. As of May 2021, four MMs with affiliated wholesaler maintain 84% of the 40,000 specialist appointments in underlying symbols across the 11 exchanges that offer such appointments. While we acknowledge the reality of this concentration of specialists and the association of these appointments with MMs and affiliated wholesalers, we believe that specialist appointments should be available to all MMs who can demonstrate the ability to satisfy the liquidity provision requirements of the role. Expanding specialist appointment opportunities to multiple MMs will contribute to a more robust marketplace and increase the likelihood for maximum price improvement.

## **PROPOSED SOLUTIONS**

The specialist model should be re-aligned to promote competition by:

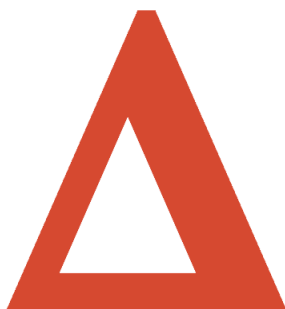
- ▲ Full removal of the specialist allocation benefits in equity option symbols where multiple market makers are willing to fulfill the specialist role.
- ▲ Allow for multiple specialists appointments for underlying symbols on the same exchange.
- ▲ A competitive and transparent specialist appointment process.
- ▲ Publicly available reviews highlighting the specialist performance by quantifiable metrics.

## **CONCLUSION**

The implementation of the specialist system in the US equity option market needs to be addressed in order to promote greater transparency and competition among market makers and therefore tighter spreads for all investors. The current system provides too great an

advantage to specialists versus the extra liquidity they provide. Heightened trade allocation rights and perpetual appointments inherently contribute to higher levels of concentration. This situation discourages competition and maximum price improvement for retail orders.

## ABOUT OPTIVER



Over thirty-five years ago, Optiver started business as a single trader on the floor of Amsterdam's European Options Exchange. Today, we are a leading technology-driven market maker, with more than 1300 employees in offices around the world, united in our commitment to improve the market by competitive pricing, execution and thorough risk management. By providing liquidity on multiple exchanges across the world in various financial instruments we participate in the safeguarding of healthy and efficient markets.

We provide liquidity to financial markets using our own capital, at our own risk, trading a wide range of products: listed derivatives, cash equities, ETFs, bonds and foreign currencies.