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Price Discovery in the U.S. Stock Options Market

Yusif E. Simaan, Liuren Wu

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Abstract

Options trading on organized exchanges began in the U.S. in the 1970s when the Chicago Board of Trade (CBOT) futures exchange founded the Chicago Board Options Exchange (CBOE), and options trading was introduced at the American Stock Exchange (Amex). The CBOE used an open-outcry approach, like the CBOT, while Amex options trading adopted a specialist system, like that used for stocks. Both exchanges grew very large, and several smaller ones also were started, with the Philadelphia Stock Exchange choosing a specialist system and the Pacific Coast Exchange using open-outcry. In 2000, the International Securities Exchange (ISE) was launched, with an entirely different all-electronic trading arrangement. The ISE model has proven highly successful, making the exchange the most active market for individual stock options within only a few years. This article describes the ISE's electronic trading technology and presents a comparison of the different exchanges' market-making systems along several dimensions, including the size of the typical bid-ask spread, how much a trade in each market contributes to a general updating of prices across the whole market, and how

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frequently trades are executed inside the quoted bid-ask spread (meaning that the quoted spread did not fully reflect the best prices available at that exchange). The results indicate that the electronic marketplace performs very well relative to the more traditional trading floors on all of these dimensions.

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