

SPEECH OF THOMAS PETERFFY  
BEFORE THE INTERNATIONAL OPTIONS MARKETS ASSOCIATION  
APRIL 12, 2005  
CHICAGO, IL

Judging by the valuation of publicly-traded electronic exchanges and brokers, we are one of the hottest growth industries in the global economy. This fact is in no small measure due to your tremendous accomplishments.

You have come to realize that the process of trade matching was conducted by highly paid professionals who could easily be replaced by cheap computers, resulting in a more than ten fold increase in productivity. By now many of these highly paid professionals either adapted to the new method of business, or left for a different environment.

In any case, your greatest challenge has been to overcome resistance to change from the both the exchange floors and the upstairs trading desks. You did it. By and large you have succeeded.

I entered the options business 28 years ago as a floor trader at the American Stock Exchange. Any day when I traded more than 500 contracts was a big day for me. Today, my firm, Interactive Brokers, including our market making unit Timber Hill, on good days, executes over 2 million equity-based option contracts, worldwide.

You have made that possible and I am here today to thank you for that. But our work is far from finished. As the aforementioned stock market valuations indicate, there is still a great deal of growth expected from us.

Some say these valuations are crazy, I say we can do even better.

Some say as more of your exchanges become publicly traded, there will be too much competition. I say there is a greater need for capacity than we can satisfy.

We are in a uniquely attractive and challenging situation. We are beginning to see the faint outlines of a **digital network** on which the global market driven economy of the future is going to be based. We are a large part of that network. Each of your exchanges is a node in that network.

We, the electronic exchanges, electronic market makers and brokers together constitute the platform on which global economic planning and resource allocation will take place.

This process is both centralized and fully distributed, in the sense that any participant from anywhere, based in any currency, has direct access to any and all nodes in the network. The number of participants is unlimited. Their size and impact is variable, but their access is equal.

Just as in the Universe at large, wherever you may be, you effectively are at the center of the network.

Having grown up in Communist Hungary, I am familiar with the theoretical advantages and the practical inviability of a centrally planned economy, as well as the theoretically inevitable boom and bust cyclicity of Capitalism.

Our network, when fully developed, with millions of participants and continuous, immediate feedback, is the solution.

Our job is to mediate and facilitate the global flow of risk capital. The more and different economic risks we apply it to, and the cheaper, the more secure and the more convenient we make this process, the more certain we can be of becoming a permanent and significant part of this evolving, global, electronic, economic nervous system.

If for the moment you are willing to indulge me and contemplate this idea, then I would like to tell you what I think you would need to do to help us get there sooner.

### **FIRST, AUTOMATE**

Your exchange has to be part of the network. If your exchange is not yet electronic, you are not in the network. If you have vital functions that are still manual, they interrupt the rapid electronic flow of the trading process. This represents a serious weakness for many of your current or potential users.

### **ELIMINATE BARRIERS TO ENTRY:**

These barriers are many: Some prohibit the ownership of domestic shares by foreigners. Others require that exchange members be domestic corporations that must be owned or directed by citizens of the home country. Some exchanges prohibit the electronic transmissions of orders from abroad and some prohibit electronic transmissions from anywhere.

These types of protectionist measures foreclose the flow of foreign capital and expertise from coming into your country and in the long term, you run the risk of being frozen out of the global network and the global economy.

### **ATTRACT MARKET MAKERS:**

In order to be a successful, high volume exchange, you must provide a liquid market with low transaction costs. This means attracting market makers, who -- by making a continuous, tight market -- reduce transaction costs for end users. Market makers will come only if they are protected by a firm, but smart, regulatory environment.

### **PROHIBIT CROSSING TRADES OUTSIDE THE MARKET:**

Market makers are risking their capital to provide firm quotes. Using these quotes when the brokers like them and trading through them when they do not disadvantages both market makers and customers. In a global electronic market, those who post the best prices should be rewarded with trades, and customers should get the best available price.

At this point I would like to congratulate Chairman Donaldson and his staff at the SEC for instituting the new no-trade-through regulation in the US, just this past week. They had the courage to do this in spite of the heavy throwing of sand in the eyes of the public by a politically driven media. Increased market efficiency will prove them right.

### **PROHIBIT TRADING ON INSIDE INFORMATION:**

We lose 20 to 30% of our revenue to insider trading, even in markets with supposedly strict rules against it. In some markets, insider trading is so bad that we have given up making markets for options on smaller stocks altogether. If retail traders or market makers come to believe that a particular market is just an insider's game, liquidity will dry up.

### **SYNCHRONIZE LISTING STANDARDS, EXPIRATION DATES AND THE MANNER IN WHICH CORPORATE ACTIONS ARE TREATED:**

This would greatly simplify the already very complex software that market makers and brokers need in order to process their trades. It would make the hedging of cross exchange positions cheaper and would reduce capital needs. Synchronized listing standards, expiration dates and corporate action treatment would also make participation easier for foreign brokers and customers.

### **CLARIFY AND OBJECTIFY ERROR POLICIES:**

Error policies must be clear and objective, they must cover all eventualities, and they must be applied consistently. We should be able to put our trades through

a filter and automatically cancel those trades that are erroneous based on clear objective standards. We cannot afford to wait sometimes for several hours to find out if a trade is deemed to be in error or not.

SPEED BUMPS must be implemented at the matching engine. No more than two quotes from the same quoting party should be allowed to be taken out at the same time without giving the quoter the ability to refresh their quotes.

Conversely, we should eliminate speed bump rules that apply at the customer level and that must be enforced by brokerage firms. Putting speed bumps at the matching engine will eliminate the need for them at the perimeters of the network.

#### PROVIDE MORE BANDWIDTH:

Bandwidth is the lifeblood of the network. More bandwidth allows market makers to update their quotes faster and therefore allows them to quote tighter markets – to the benefit of the end users.

#### **ATTRACT BROKERS AND CUSTOMERS:**

In addition to attracting professional liquidity providers, exchanges obviously must attract brokers and their customers.

One of the most pressing needs in this regard is to STREAMLINE REGULATIONS AND BUREAUCRACY.

Our regulatory policies must be aimed at strictly punishing those who intentionally or recklessly harm customers, but without dragging down legitimate firms with aimless, ever-expanding rules and investigations.

We are currently in a regulatory environment where, because we are unable to catch the murderers in advance, we are issuing more parking tickets to old ladies. Exchanges and regulators have to use their judgment very carefully. Enforcing anti-fraud and other important customer protection rules vigorously leads to clean, fair markets that inspire confidence. On the other hand, overreacting and failing to exercise any prosecutorial discretion with respect to minor administrative issues simply raises transaction costs on customers and undermines confidence in the markets as the public simply determines that everyone must be a crook.

Simply stated, you can not just endlessly make new rules and delegate their enforcement without following up on how they practically impact market

participants. You must take ONGOING RESPONSIBILITY FOR YOUR RULES AND REGULATIONS AND THE POLICY BEHIND THEM AND THE MANNER IN WHICH THEY ARE ENFORCED.

As active members on over 50 different exchanges, we are always under routine examination by several different regulators at the same time. Working with examiners has become one of our largest expenses. We would like to encourage Exchanges to coordinate and streamline their regulatory efforts. This would take a large cost out of the system and benefit customers.

In addition to sensible regulation, CREDIBLE, STABLE CLEARING facilities are absolutely essential, in order to eliminate systemic risk. We have had quiet, orderly markets for some time and may not be prepared for a sudden shock that may come at any time. Regular coordination and information sharing among clearing houses would go a long way towards dealing with the next market crisis.

Indeed, establishing A GLOBAL UNION of CLEARING HOUSES would be a wonderful way to accelerate the globalization of markets.

Finally and most importantly, EXCHANGES MUST ADD PRODUCTS that facilitate the efficient transfer of economic risk. Products that are successful in the over the counter market are likely to be even more successful with added liquidity, transparency and reduced counterparty risks that you can provide.

We need more:

- FOREIGN EXCHANGE and INTEREST RATE products.
- CREDIT DEFAULT SWAPS
- CORPORATE DEBT DERIVATIVES
- ECONOMIC INDICATOR and INDEX DERIVATIVES
- INSURANCE PRODUCTS
- VARIOUS FORMS OF ENERGY, CHEMICALS, TRANSPORTATION AND HOUSING DERIVATIVES

I would like to encourage you to invest in new product development.

\* \* \*

To summarize: Technology has given us the opportunity and the means of spreading the benefits of a market driven, entrepreneurial economy to every corner of the world.

As our network grows, more local nodes with more local products will be attached to it. More would-be small businesses and their financial backers will be able to hedge the risks that currently prevent them from establishing or expanding operations.

We should rise to the occasion, accept the challenge, grow our network, and do our part to increase living standards across the globe.

Thank you very much for having me.