

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-89635; File No. SR-CBOE-2020-050)

August 21, 2020

Self-Regulatory Organizations; Cboe Exchange, Inc.; Notice of Filing of Amendment Nos. 1 and 2 and Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, as Modified by Amendment Nos. 1 and 2, to Amend Rules 5.37 and 5.73 Related to the Solicitation of Market Makers for SPX Initiating Orders in the Automated Improvement Mechanism and FLEX Automated Improvement Mechanism

I. Introduction

On June 3, 2020, Cboe Exchange, Inc. (“Exchange” or “Cboe”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to permit orders for the accounts of market makers with an appointment in S&P 500® Index Options (“SPX”) to be solicited for the initiating order submitted for execution against an agency order into an Automated Improvement Mechanism (“AIM”) auction or a FLEX AIM auction. The proposed rule change was published for comment in the Federal Register on June 18, 2020.³ On July 2, 2020, the Exchange submitted Amendment No. 1 to the proposed rule change, which replaced and superseded the proposed rule change in its entirety.⁴ On July 22, 2020, the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 89062 (June 12, 2020), 85 FR 36907. Comments received on the proposed rule change are available on the Commission’s website at: <https://www.sec.gov/comments/sr-cboe-2020-050/srcboe2020050.htm>.

⁴ In Amendment No. 1, the Exchange: (1) limited the scope of its original proposal, which would have permitted orders for the accounts of market makers with an appointment in any class to be solicited for the initiating order in an AIM or FLEX AIM auction in that class, to only allow market makers with an appointment in SPX to be solicited for the initiating order in an AIM or FLEX AIM auction in SPX; and (2) provided additional data, justification, and support for its modified proposal. The full text of Amendment No. 1 is available on the Commission’s website at: <https://www.sec.gov/comments/sr-cboe-2020-050/srcboe2020050-7382058-218888.pdf>.

Exchange submitted Amendment No. 2 to the proposed rule change.⁵ On July 27, 2020, pursuant to Section 19(b)(2) of the Act,⁶ the Commission designated a longer period within which to approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to disapprove the proposed rule change.⁷ The Commission is publishing this notice and order to solicit comment on the proposed rule change, as modified by Amendment Nos. 1 and 2, from interested persons and to institute proceedings pursuant to Section 19(b)(2)(B) of the Act⁸ to determine whether to approve or disapprove the proposed rule change, as modified by Amendment Nos. 1 and 2.

II. Exchange's Description of the Proposed Rule Change, as Modified by Amendment Nos. 1 and 2

The Exchange proposes to permit orders for the accounts of Market-Makers with an appointment in SPX to be solicited for the Initiating Order⁹ submitted for execution against an Agency Order in SPX options into a simple AIM Auction pursuant to Rule 5.37 or a simple FLEX AIM Auction pursuant to Rule 5.73. The Exchange does not generally activate AIM for

⁵ In Amendment No. 2, the Exchange: (1) provided additional data, justification, and support for its proposal; and (2) made technical corrections and clarifications to the description of the proposal. The full text of Amendment No. 2 is available on the Commission's website at: <https://www.sec.gov/comments/sr-cboe-2020-050/srcboe2020050-7464399-221161.pdf>.

⁶ 15 U.S.C. 78s(b)(2).

⁷ See Securities Exchange Act Release No. 89398, 85 FR 46197 (July 31, 2020). The Commission designated September 16, 2020 as the date by which the Commission shall approve or disapprove, or institute proceedings to determine whether to disapprove, the proposed rule change.

⁸ 15 U.S.C. 78s(b)(2)(B).

⁹ The "Initiating Order" is the order comprised of principal interest or a solicited order(s) submitted to trade against the order the submitting Trading Permit Holder (the "Initiating TPH" or "Initiating FLEX Trader," as applicable) represents as agent (the "Agency Order").

SPX options, and AIM for SPX options is currently not activated.¹⁰ The introductory paragraphs of Rules 5.37 and 5.73 prohibit orders for the accounts of Market-Makers with an appointment in the applicable class to be solicited to execute against the Agency Order in a simple AIM or FLEX AIM Auction, respectively. No similar restriction applies to crossing transactions in open outcry trading, where a significant portion of SPX options trade.¹¹ As further discussed below, brokers seeking liquidity to execute against customer orders on the trading floor regularly solicit appointed SPX Market-Makers for this liquidity, as they are generally the primary source of pricing and liquidity for those options.

As of March 16, 2020, the Exchange suspended open outcry trading to help prevent the spread of the novel coronavirus and began operating in an all-electronic configuration.¹² As a result, the Exchange activated AIM for SPX options for the first time to provide market participants with a mechanism to cross SPX options while the floor was inoperable, which would otherwise not be possible without open outcry trading. The Exchange adopted a temporary rule change to permit Market-Makers to be solicited for electronic crossing transactions in its exclusively listed index options (including SPX options) when the Exchange's trading floor was inoperable. The Exchange believed this would make the same sources of liquidity for customer orders that are generally available in open outcry available for those orders in an electronic-only environment.¹³ This was particularly true for SPX options, for which the Exchange enabled AIM for the first time. The Exchange believed not permitting Market-Makers to participate as contras

¹⁰ FLEX AIM is generally activated, and currently is activated, for FLEX SPX options.

¹¹ See Rules 5.86 and 5.87.

¹² The Exchange continues to operate in an all-electronic environment, but currently plans to reopen its trading floor on June 8, 2020.

¹³ See Rule 5.24(e)(1)(A); see also Securities Exchange Act Release No. 88886 (May 15, 2020), 85 FR 31008 (May 21, 2020) (SR-CBOE-2020-047).

could have made it difficult for brokers to find sufficient liquidity to fill their customer orders, which liquidity they generally solicited from SPX Market-Makers on the trading floor. For example, when the Exchange operates in its a hybrid manner as it currently is (with electronic and open outcry trading), if a customer order is not fully executable against electronic bids and offers, a floor broker can attempt to execute the order, or remainder thereof, on the trading floor, where the liquidity to trade with this remainder is generally provided by Market-Makers in the open outcry trading crowd. Additionally, brokers may solicit liquidity from upstairs Market-Maker firms.

Upon the reopening of the trading floor, the Exchange deactivated AIM for SPX options. While AIM was activated for SPX options, the Exchange observed price improvement benefits AIM auctions provided to smaller, retail-sized SPX options.¹⁴ As a result, the Exchange intends to reactivate AIM for SPX options while the trading floor is operable for orders up to a maximum size to continue to provide these price improvement opportunities for retail-sized SPX orders.¹⁵ Regardless of whether the trading floor is open, the Exchange believes brokers will have difficulty finding sufficient liquidity to initiate AIM auctions from only market participants that are not SPX Market-Makers. If the Exchange determines to reactivate AIM for SPX options, the Exchange believes it is appropriate to permit orders for the account of an appointed SPX Market-Maker to be submitted as the contra order, as the Exchange believes the liquidity provided by SPX Market-Makers will need to be available for brokers to initiate AIM Auctions and create potential price improvement opportunities for those retail-sized orders. Currently, there are 28 TPHs with SPX appointments, which represent a significant pool of SPX liquidity

¹⁴ See Securities Exchange Act Release No. 89058 (June 12, 2020), 85 FR 36918 (June 18, 2020) (SR-CBOE-2020-051).

¹⁵ Id.

that would be available to participate in AIM Auctions through both contra orders and auction responses. To demonstrate the importance of the liquidity provided by SPX Market-Makers, in January and February 2020, the percentage of smaller simple Customer orders (20 or fewer) that executed in open outcry against an SPX Market-Maker as contra was approximately 85%, and the percentage of smaller simple Customer orders (20 or fewer) that executed electronically against an SPX Market-Maker as contra was approximately 87%. If SPX Market-Makers cannot be solicited for SPX AIM Auctions, the Exchange believes brokers may not be able to initiate as many AIM Auctions for their retail orders as they were able to do while the trading floor was closed, which may reduce the price improvement opportunities available for those orders. While the trading floor was closed, orders for the accounts of SPX Market-Makers created opportunities for customer orders to be submitted in AIM Auctions and receive price improvement. The Exchange believes those SPX Market-Maker orders should be permitted to be solicited at all times for SPX AIM Auctions in order to create similar price improvement opportunities for those customer orders.

In multi-list classes, many market-makers serve as both appointed Market-Makers on the Exchange and as market-makers on other options exchanges. These firms, as a result, can use their accounts for their away market-maker activities for being solicited with respect to AIM Auctions. In general, solicited orders submitted as the Initiating Order for AIM Auctions are almost always comprised of orders for the accounts of away market-makers. For example, in April of 2020, approximately 99.6% of the orders submitted into all AIM Auctions had Initiating Orders comprised of orders for accounts of away market-makers, making up approximately 86.2% of the volume executed through AIM auctions. However, SPX is an exclusively listed class on the Exchange, so a firm cannot serve as an SPX market-maker at another options

exchange. During April and May 2020, when Initiating Orders could be comprised of orders for accounts of SPX Market-Makers pursuant to a temporary rule, approximately 22% of Initiating Orders executed in SPX AIM Auctions were comprised of orders for SPX Market-Makers, representing approximately 45% of SPX volume executed in AIM Auctions. While approximately 76% of Initiating Orders executed in SPX AIM Auctions were comprised of orders for accounts of away market-makers, those orders represented only approximately 5% of the SPX volume executed through AIM Auctions. The Exchange notes SPX Market-Makers also executed approximately 31% of SPX volume executed through AIM Auctions with auction responses. This demonstrates the difficulty brokers may have to find sufficient interest to fill customer orders in SPX if the Exchange activates AIM for SPX without permitting appointed Market-Makers to be solicited. If brokers may solicit primary liquidity providers in SPX for electronic auctions, regardless of whether the trading floor is operational, the Exchange believes brokers will be able to more efficiently locate liquidity to initiate AIM Auctions to fill their customer orders, particularly during times of volatility, which may create additional execution and price improvement opportunities for customers at all times. The Exchange believes the proposed rule change will, therefore, provide retail-sized orders with similar price improvement opportunities when AIM is activated while the trading floor is open that those orders realized while the trading floor was closed.

Permitting SPX Market-Makers to serve as contra parties to crossing transactions submitted into an AIM Auction will also further align AIM Auctions with SPX crossing executions that occur on the trading floor. SPX Market-Makers frequently serve as contra parties to crossing transactions on the trading floor. For example, during February 2020 (when the trading floor was open), approximately 76% of SPX orders crossed on the trading floor

(consisting of 2,944,161 contracts) included an order of an SPX Market-Maker one side of the transaction.

This further demonstrates the importance of appointed SPX Market-Makers to the provision of liquidity in the SPX market with respect to crossing transactions, which liquidity would not be available to initiate electronic crossing transactions under the current AIM rule. Therefore, the Exchange believes the proposed rule change will permit it to activate AIM in SPX in a manner that aligns open outcry and electronic crossing auctions, and thus aligns the execution and price improvement opportunities available in both auctions, by permitting the same participants to be solicited as contras in both types of auctions in SPX at all times.

While FLEX AIM is currently available for SPX orders of all sizes, the Exchange believes brokers currently have similar difficulties locating liquidity to initiate FLEX AIM Auctions for SPX orders. Unlike in simple non-FLEX markets, FLEX Market-Makers have no obligations to provide liquidity to FLEX classes (and there is book into which FLEX Market-Makers may submit quotes to rest). Therefore, in FLEX markets, appointed Market-Makers are on equal footing with all other market participants with respect to FLEX AIM Auctions. Permitting FLEX Market-Makers to be solicited provides all market participants with the opportunity to provide liquidity to execute against Agency Orders in FLEX AIM Auctions in the same manner (both through solicitation and responses). The Exchange believes the proposed rule change may result in additional FLEX AIM auctions occurring in SPX, which may create additional price improvement opportunities for FLEX SPX orders.¹⁶ The Exchange also believes

¹⁶ The Exchange notes Market-Makers are currently able to be solicited for complex AIM and complex FLEX AIM for similar reasons. See Rules 5.38 and 5.73.

permitting FLEX SPX Market-Makers to be solicited for FLEX AIM Auctions will provide consistency among electronic crossing auctions for SPX.

The proposed rule change also amends Rules 5.37(c)(5) and 5.73(c)(5) to codify that any User or FLEX Trader, respectively, other than the Initiating TPH or FLEX Trader, respectively, may submit responses to AIM and FLEX AIM Auctions. As set forth in Rules 5.37(e) and 5.73(e), the Initiating Order may receive an entitlement of 40% or 50% of the Agency Order. The Exchange believes it is appropriate to not permit the Initiating TPH or Initiating FLEX Trader, as applicable, to also submit responses in order to try to trade against a larger percentage of the Agency Order. This is consistent with allocation rules, pursuant to which the Initiating Order may only receive more than 40% or 50%, as applicable, of the Agency Order if there are remaining contracts after all other interest has executed.

The Rule change also notes that the System will reject a response with the same EFID¹⁷ as the Initiating Order. The Exchange notes that orders for the same User may have different EFIDs. However, the rule prohibits all responses from the same User, even with different EFIDs. The System is currently only able to reject responses with the same EFID as the Initiating Order, which is why that is specified in the proposed rule. If the same User submits a response to an auction in which that same User had an order comprising the Initiating Order (even with a different EFID), the Exchange may take regulatory action against that User for a violation of the proposed rule. The Exchange currently applies this restriction to simple AIM and FLEX AIM Auctions, but it was inadvertently omitted from the Rules, so the proposed rule change adds transparency to the Rules.

¹⁷ See Rule 1.1, which defines EFID as an Executing Firm ID.

This restriction is also currently in the Rules related to AIM for complex orders, so the proposed rule change adds consistency to the rules of Exchange auctions.¹⁸

III. Summary of the Comment Letters Received

To date the Commission has received two comment letters on the proposal.¹⁹ The commenters agreed with Cboe's assertions that the proposal would increase liquidity for AIM auctions, which could increase execution and price improvement opportunities.²⁰ One commenter argued that removing the market maker solicitation prohibition would eliminate an inequity against market makers that unduly curtails liquidity to customer orders.²¹ This commenter argued that, because Cboe's rules no longer restrict AIM and FLEX AIM responses to appointed market makers and trading permit holders representing customer orders at the top of the book, the market maker solicitation prohibition is no longer necessary.²² The commenters also supported the proposal because it would better align the execution and price improvement opportunities in electronic crossing auctions with those available in open outcry trading, where no similar solicitation prohibition exists.²³

¹⁸ See Rule 5.38(c)(5).

¹⁹ See letters to Vanessa Countryman, Secretary, Commission, from Richard J. McDonald, Susquehanna International Group, LLP, dated July 8, 2020 ("SIG Letter") and Ellen Greene, Managing Director, Equities & Options Market Structure, The Securities Industry and Financial Markets Association, dated July 9, 2020 ("SIFMA Letter").

²⁰ See SIG Letter, supra note 19, at 2 and SIFMA Letter, supra note 19, at 3.

²¹ See SIG Letter, supra note 19, at 1.

²² See id. at 2.

²³ See id.; SIFMA Letter, supra note 19, at 3.

IV. Proceedings to Determine Whether to Approve or Disapprove SR-CBOE-2020-050, as Modified by Amendment Nos. 1 and 2, and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Act²⁴ to determine whether the proposed rule change should be approved or disapproved. Institution of such proceedings is appropriate at this time in view of the legal and policy issues raised by the proposed rule change. Institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, as stated below, the Commission seeks and encourages interested persons to provide additional comment on the proposed rule change, as modified by Amendment Nos. 1 and 2, to inform the Commission's analysis of whether to approve or disapprove the proposed rule change.

Pursuant to Section 19(b)(2)(B) of the Act,²⁵ the Commission is providing notice of the grounds for disapproval under consideration. The Commission is instituting proceedings to allow for additional analysis of the proposed rule change's consistency with Section 6(b)(5) of the Act, which requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulate acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and to protect investors and the public interest, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers;²⁶ and Section

²⁴ 15 U.S.C. 78s(b)(2)(B).

²⁵ 15 U.S.C. 78s(b)(2)(B).

²⁶ 15 U.S.C. 78f(b)(5).

6(b)(8) of the Act, which requires that the rules of the Exchange do not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.²⁷

Under the Commission’s Rules of Practice, the “burden to demonstrate that a proposed rule change is consistent with the [Act] and the rules and regulations issued thereunder . . . is on the self-regulatory organization that proposed the rule change.”²⁸ The description of a proposed rule change, its purpose and operation, its effect, and a legal analysis of its consistency with applicable requirements must all be sufficiently detailed and specific to support an affirmative Commission finding,²⁹ and any failure of a self-regulatory organization to provide this information may result in the Commission not having a sufficient basis to make an affirmative finding that a proposed rule change is consistent with the Act and the applicable rules and regulations.³⁰

The Commission is instituting proceedings to allow for additional consideration and comment on the issues raised herein, including as to whether the proposal is consistent with the Act.

V. Procedure: Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the issues identified above, as well as any other concerns they may have with the proposal. In particular, the Commission invites the written views of interested persons concerning whether the proposal is consistent with Sections 6(b)(5) and 6(b)(8), or any other provision of the Act, or the rules and regulations thereunder. Although

²⁷ 15 U.S.C. 89f(b)(8).

²⁸ Rule 700(b)(3), Commission Rules of Practice, 17 CFR 201.700(b)(3).

²⁹ See id.

³⁰ See id.

there do not appear to be any issues relevant to approval or disapproval that would be facilitated by an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4 under the Act,³¹ any request for an opportunity to make an oral presentation.³²

Interested persons are invited to submit written data, views, and arguments regarding whether the proposal should be approved or disapproved by [insert date 21 days from publication in the Federal Register]. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by [insert date 35 days from publication in the Federal Register]. Commission may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-CBOE-2020-050 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-CBOE-2020-050. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all

³¹ 17 CFR 240.19b-4.

³² Section 19(b)(2) of the Act, as amended by the Securities Act Amendments of 1975, Pub. L. 94-29 (June 4, 1975), grants the Commission flexibility to determine what type of proceeding – either oral or notice and opportunity for written comments – is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Act Amendments of 1975, Senate Comm. on Banking, Housing & Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 30 (1975).

comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-CBOE-2020-050, and should be submitted on or before [insert date 21 days from publication in the Federal Register]. Rebuttal comments should be submitted by [insert date 35 days from the date of publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³³

J. Matthew DeLesDernier
Assistant Secretary

³³ 17 CFR 200.30-3(a)(57).