SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-95707; File No. SR-CBOE-2022-036)

September 8, 2022

Self-Regulatory Organizations; Cboe Exchange, Inc.; Order Approving a Proposed Rule Change to Amend Cboe Rule 5.6 and Cboe Rule 5.33 to Allow Delta-Adjusted at Close Orders to be Submitted in FLEX Equity Options

I. Introduction

On July 8, 2022, Cboe Exchange, Inc. ("Cboe" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act")[1] and Rule 19b-4 thereunder,[2] a proposed rule change to allow the Delta-Adjusted at Close ("DAC") Order Instruction to be submitted in FLEX equity options on the Exchange. The proposed rule change was published for comment in the Federal Register on July 27, 2022.[3] The Commission has received no comment letters on the proposal. This order approves the proposed rule change.

II. Description of the Proposed Rule Change

The Exchange proposes to amend Cboe Rule 5.6 (for simple DAC orders) and Cboe Rule 5.33 (for complex DAC orders) to allow DAC orders to be submitted in any FLEX option, including equity options, except that a simple DAC order submitted in a single stock equity option may not be submitted until 45 minutes prior to the market close and may not be submitted on its expiration day.[4]

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 95344 (July 21, 2022), 87 FR 45138 ("Notice").

4 The Exchange notes that references to equity options and equity securities within this proposed rule change refers to options on securities that are not exchange-traded products ("ETPs") and equity securities that are not ETPs (i.e., single stock securities),

A DAC order is an order for which the System[5] delta-adjusts its execution price after the market close.[6] Currently, the DAC order instruction is available for simple[7] and complex[8] FLEX orders in options on ETPs and indexes for execution in a FLEX electronic auction or open outcry auction on the Exchange's trading floor pursuant to Rule 5.72.[9] A DAC order allows Users to incorporate into their options pricing the closing price or value of the underlying on the transaction date based on how much that price or value changed during the trading day. After the close of trading and upon receipt of the official closing price or value for the underlying ETP or index from the primary listing exchange or index provider, as applicable, the System adjusts the original execution price of the order based on a pre-determined delta value applied to the change in the underlying reference price between the time of execution and the market close.[10]

The Exchange states that DAC orders are designed to allow investors to incorporate any upside market moves that may occur following execution of the order up to the market close while

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respectively. Under this proposal, DAC orders will continue to be available only for FLEX options. For a more detailed description of the proposed rule change, see Notice. Id.

5 The term "System" means the Exchange's hybrid trading platform that integrates electronic and open outcry trading of option contracts on the Exchange, and includes any connectivity to the foregoing trading platform that is administered by or on behalf of the Exchange, such as a communications hub. See Cboe Rule 1.1.

6 See Cboe Rule 5.6(c) and Cboe Rule 5.33(b)(5). See also Securities Exchange Act Release No. 90319 (November 3, 2020), 85 FR 71361 (November 9, 2020) (SR-CBOE-2020-014) ("DAC Approval Order").

7 See Cboe Rule 5.6(c).

8 The DAC order instruction would apply to each leg of a complex order. See Cboe Rule 5.33(b)(5).

9 In addition, pursuant to the definition of a DAC order under Cboe Rule 5.6(c) and Cboe Rule 5.33(b)(5), a DAC order submitted for execution in open outcry may only have a Time-in-Force of Day. A User may not designate a DAC order as All Sessions.

10 See Notice, supra note 3, at 45138, for a more detailed description of a DAC order.

limiting downside risk. The Exchange states that significant numbers of market participants interact in the equity markets near the market close, which may substantially impact the price of an underlying equity security at the market close. For example, the Exchange understands that market makers and other liquidity providers seek to balance their books before the market close and contribute to increased price discovery surrounding the market close. The Exchange also understands it is common for other market participants to seek to offset intraday positions and mitigate exposure risks based on their predictions of the closing underlying prices. The Exchange notes that this substantial activity near the market close may create wider spreads and increased price volatility, which may attract further trading activity from those participants seeking arbitrage opportunities and further drive prices. The significant liquidity and price/value movements in securities, including equity securities, that can occur near the market close may cause option closing and settlement prices to deviate significantly from option execution prices earlier that trading day. As such, the Exchange wishes to provide its investors with the same opportunities to incorporate any upside market moves that may occur following execution of the order up to the market close while limiting downside risk in their equity options trading as currently provided for their ETP and index options trading by making DAC orders available in equity options.

The Exchange states that DAC orders are intended to benefit investors that participate in defined-outcome strategies,[11] which, at the time the DAC order was adopted, existed only for indexes and ETPs. Particularly, DAC orders allow such funds to employ certain FLEX options strategies that enable their investors to mitigate risk at the market close while also participating in

11 Including defined-outcome ETFs, other managed funds, unit investment trusts index funds, structured annuities, and other such funds or instruments that are indexed managed funds.

beneficial market moves at the close.[12] The Exchange states that it has recently been made aware that defined-outcome investment strategies are being created to provide exposure to individual equity securities and as a result has received growing customer demand to make DAC orders available in equity options. The Exchange understands that, like defined-outcome strategies for ETPs and indexes, such funds for single stock equity securities would seek to use multi-leg strategy orders when seeding their funds,[13] and, like for any defined-outcome strategy, the goal of the strategies used by defined-outcome funds for single stock securities would be to price the execution of multi-leg strategy orders at the close of the underlying. Also, the Exchange understands that funds for multiple single stock equity securities would seek to use single-leg (i.e., simple) orders to create a strategy when seeding their funds.[14] However, there is operational execution risk in attempting to fill an order near the close to capture the underlying closing price. A DAC complex order currently allows the User to execute a strategy order in connection with a fund for an ETP or an index prior to the close and have its price adjusted at the close. The proposed rule change would allow a User to execute strategy orders in connection with seeding a fund for an equity security in the same manner.[15] Like DAC complex orders for strategy orders in

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12 See DAC Approval Order, supra note 6.

13 The Exchange understands that, like defined-outcome ETFs for ETPs and indexes, issuers of defined-outcome ETFs for equity securities would not buy stocks directly, but instead, use options contracts to deliver the price gain or loss of the underlying over the course of a year, up to a preset cap.

14 The Exchange notes that funds for multiple single stock equity securities would seek to use simple orders across multiple single stock equity options when seeding their funds as multi-leg, multi-class strategies in single stock options are not available for trading on the Exchange.

15 The Exchange states that because multi-leg strategies themselves may have delta offsets, the User is hedged, meaning that the User may realize a negative movement versus the initial execution on some legs, which is offset by a positive move in other legs. The Exchange notes that the strategies may or may not define an exact delta offset ("delta neutrality" occurs where the strategy defines an exact delta offset). Given the delta

ETP and index options currently, DAC orders in equity options, either simple or complex depending on the structure of the fund, would allow the strategy order or orders to be executed at a time before the close, eliminating the execution risk, while realizing the objective of pricing based on the exact underlying close for those strategies that require pricing at the close or a defined amount of market exposure through the close. The Exchange states that the proposed rule change would allow Users to participate in the same benefits – eliminating execution risk while realizing objective pricing – for their strategies in equity options as they currently may for their strategies in ETP and index options.

Consistent with the foregoing rationale, the Exchange proposes to make the DAC order instruction available for orders submitted in any FLEX option, including equity options. In particular, the proposed rule change amends the definition of a DAC order (simple and complex)[10] to allow for DAC orders to be submitted in equity options by removing the restriction that a DAC order may only be submitted in options on ETPs and indexes.[16] In addition, the amended definition of a simple DAC order under Cboe Rule 5.6(c) provides that a DAC order in a single stock equity option may not be submitted (1) until 45 minutes prior to the market close and (2) on its expiration day.

The Exchange proposes to limit the use of the DAC orders in equity options until 45 minutes prior to the market close and on its expiration day to mitigate manipulation concerns.

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neutral nature of an order with exact offset, a User is indifferent to any movement in the underlying from the time of execution to the close. Whether a User defines an exact delta offset, a User anticipates a given amount of market exposure, either partial or none, depending on the strategy and combinations of buy/sell, call/put and quantity. See Notice, supra note 3, at 45139 n.10.

16 The amended definition of a simple DAC order under Cboe Rule 5.6(c) also provides that a DAC order may only be submitted for execution in a FLEX electronic auction or open outcry auction on the Exchange’s trading floor pursuant to Cboe Rule 5.72.

Specifically, the Exchanges notes that single stock equity securities tend to be less liquid and experience greater price sensitivity and larger market moves than indexes or ETPs and increased trading volume generally makes it more difficult to manipulate the price of a security. The Exchange notes that on expiration day in particular, underlying equity securities may experience more price sensitivity and may be more susceptible to manipulation than on non-expiration days.[17] Similarly, the Exchanges proposes that simple DAC orders in single stock options be required to be submitted no earlier than 45 minutes before the market close in order to reduce the amount of time that the underlying price could potentially move in order to mitigate the risk upon price adjustment at close to holders of DAC options.[18]

Under this proposal, the current rules regarding the entry, execution and processing of DAC orders submitted in ETP and index options would apply to DAC orders submitted in equity options.[19] In addition, unadjusted and adjusted DAC trade information for DAC orders in equity

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17 Options holders on expiration day, whether their positions were taken via a DAC execution, are subject to the risk of price swings in the underlying prior to the final close; however, options holders of positions taken via a DAC execution may potentially be more susceptible to such risk given the price adjustment at the close. For example, if a market participant executes a DAC order to buy calls on expiration day and a large price swing follows, in that, the underlying price is pushed significantly higher before the close, the DAC option holder would be forced to pay a much higher premium upon adjustment, and ultimately expiration. Therefore, in order to mitigate the potential risk associated with expiration day price swings, which may potentially expose DAC order users the gamma effect of options as they become more sensitive to underlying price changes as they approach expiration, particularly in options overlying less liquid securities, the proposed rule change restricts trading (regardless of opening or closing) in simple DAC orders in single stock options on expiration day. See Notice, supra note 3, at 45139.

18 The Exchange notes that the same potential incentive to "push" the price of the underlying on expiration day in connection with the exercise price of an option is greatly diminished for multi-leg orders given that parties to multi-leg transactions are focused on the spread or ratio between the transaction prices for each of the legs (i.e., the net price of the entire complex trade). See id.

19 See Cboe Rule 5.6(c) (definition of simple DAC order), Cboe Rule 5.33(b)(5) (definition of complex DAC order), and Rule 5.34(c)(11) (DAC order reasonability check). The

options would be sent to the transacting parties, Options Clearing Corporation ("OCC") and Options Price Reporting Agency ("OPRA") in the same manner as such trade information for DAC orders in ETP and index options is sent today.

Finally, Cboe represents that it has analyzed its capacity and that it believes that OPRA and it have the necessary systems capacity to handle any additional order traffic, and the associated restatements, that may result from the submission of DAC orders in equity options and represents that it continues to have an adequate surveillance program in place to monitor orders with DAC pricing, including such orders in equity options. The Exchange also represents that it has not observed any impact on pricing or price discovery at or near the market close as a result of DAC orders submitted in ETP and index options and does not believe that making DAC orders available in equity options will have any impact on pricing or price discovery at or near the market close.

III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to a national securities exchange.[20] In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Exchange Act,[21] which requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, to remove impediments to and perfect the

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Exchange notes too that all DAC orders, currently and as proposed, are entered, priced, prioritized, allocated and execute as any other FLEX Order would when submitted into any FLEX electronic or open outcry auction and, like any FLEX Order, a FLEX DAC order may only be submitted into FLEX Options series eligible for trading pursuant to the FLEX Rules.

20 In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

21 15 U.S.C. 78f(b)(5).

mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

The Exchange proposes to expand the DAC order instruction, currently available for FLEX options on ETPs and indexes, to any FLEX option, including equity options. As with existing DAC orders for ETPs and indexes, DAC orders on single stock equity options will be available for use with both simple and complex orders in electronic or open outcry auctions. In addition, simple DAC orders submitted in a single stock equity option may not be submitted until 45 minutes prior to the market close and may not be submitted on its expiration day. In all other material respects, DAC orders in single equity options will operate the same way as DAC orders on ETPs and indexes. The Exchange states that the same rules regarding the entry, execution and processing of DAC orders submitted in ETP and index options will apply to DAC orders submitted in equity options.[22] The Exchange states that the DAC order instruction will allow market participants to incorporate into the pricing of their FLEX options the closing price of the underlying on the transaction date, based on the amount in which the price or value of the underlying changes intraday.[23] The Exchange also states that the DAC order will be useful to investors that engage in defined-outcome strategies and that certain defined-outcome strategies are being created to provide exposure to individual equity securities.[24]

The Commission believes that the proposed rule change is reasonably designed to allow market participants to more effectively incorporate the closing price of the underlying into the

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22 See Notice, supra note 3, at 45139-45140.

23 See id. at 45140.

24 See id.

execution price of the FLEX equity option, which should facilitate the ability of market participants to execute certain investment strategies. Specifically, as the Exchange notes, the DAC order instruction would allow FLEX equity option orders to be executed at a time before the close, eliminating execution risk near the market close and thereby realizing the objective of pricing based on the exact underlying closing prices.

The Commission notes that all DAC orders, including DAC orders in single stock equity options, will be entered and processed pursuant to the existing FLEX rules like any other order that is submitted into a FLEX electronic or open outcry auction.[25] The Commission believes that certain market participants already use the DAC order instruction for options on ETPs and indexes to achieve certain investment strategies, and that market participants should have familiarity with the use of the DAC order instruction on single stock equity options for similar purposes.

Additionally, the Commission believes that the proposed restrictions in connection with the submission of simple DAC orders in equity options are designed to prevent fraudulent and manipulative acts and practices and protect investors by mitigating the potential risk associated with expiration day price swings, which may potentially expose DAC order users to the gamma effect of options as they become more sensitive to underlying price changes as such options approach expiration, and reducing the amount of time during which the underlying price could potentially move. As described in the Notice,[26] single stock securities may experience greater price sensitivity and may experience larger price swings than compared to indexes and ETPs, and DAC options holders particularly may potentially be subject to a greater risk of paying much higher premiums given the price adjustment at close. The Commission believes the proposed

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25 See Cboe Rule 5.72(d).

26 See Notice, supra note 3, at 45139.

restrictions are designed to minimize any potential incentive to attempt to manipulate the equities that may underlie a DAC order, particularly those securities that may experience relatively lower volume, and are designed to mitigate potential risk to holders of DAC options on single stock securities.

Finally, the Commission notes that the Exchange represents that: (1) it believes the Exchange and OPRA have the necessary systems capacity to handle any additional order traffic, and the associated restatements, that may result from the submission of DAC orders in equity options; (2) it continues to have an adequate surveillance program in place to monitor orders with DAC pricing, including such orders in equity options; (3) it intends to further enhance its surveillances to, among other things, monitor for certain changes in delta and stock price between an original order and the final terms of execution and to generally monitor activity in the underlying potentially related to DAC trades; (4) it has not observed any impact on pricing or price discovery at or near the market close as a result of DAC orders submitted in ETP and index options and does not believe that making DAC orders available in equity options will have any impact on pricing or price discovery at or near the market close; and (5) it has not identified an impact on pricing or price discovery at or near the close as a result of exercise prices for FLEX Equity Options series formatted as a percentage of the closing value of the underlying security, which is similar to a DAC order instruction and currently permitted on the Exchange.

Accordingly, for the foregoing reasons, the Commission believes that this proposed rule change is consistent with the Exchange Act.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,[27] that the proposed rule change (SR-CBOE-2022-036) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[28]

J. Matthew DeLesDernier

Deputy Secretary

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[27] 15 U.S.C. 78s(b)(2).

[28] 17 CFR 200.30-3(a)(12).