

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-81084; File No. SR-BatsBZX-2017-35)

July 6, 2017

Self-Regulatory Organizations; Bats BZX Exchange, Inc.; Order Granting Approval of a Proposed Rule Change to Amend Rule 20.6, Nullification and Adjustment of Options Transactions including Obvious Errors, and Rule 20.3, Trading Halts

I. Introduction

On May 5, 2017, Bats BZX Exchange, Inc. (the “Exchange” or “BZX”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),¹ and Rule 19b-4 thereunder,² a proposed rule change to amend Exchange Rule 20.6 (“Rule 20.6”), relating to the adjustment and nullification of transactions that occur on the Exchange’s equity options platform, and Exchange Rule 20.3 (“Rule 20.3”), relating to trading halts. The proposed rule change was published for comment in the Federal Register on May 23, 2017.³ The Commission received no comments regarding the proposal. This order approves the proposed rule change.

II. Description of the Proposed Rule Change

The Exchange proposes to amend Rule 20.6, entitled “Nullification and Adjustment of Options Transactions including Obvious Errors,” to: (i) adopt procedures to determine Theoretical Price in the event a reliable national best bid or offer (“NBBO”) is not available; and (ii) expand the category of invalid quotes. The Exchange also proposes to amend Rule 20.3, entitled “Trading Halts,” to require the Exchange to nullify any transaction that occurs during a

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 80709 (May 17, 2017), 82 FR 23684 (“Notice”).

regulatory halt on the primary listing market for the underlying security.

A. Background

The Exchange and other options exchanges previously adopted new, harmonized rules related to the adjustment and nullification of erroneous options transactions.⁴ The Exchange believes that the changes the options exchanges implemented with the new, harmonized rules have led to increased transparency and finality with respect to the adjustment and nullification of erroneous options transactions.⁵ However, as part of the initial initiative, the Exchange and other options exchanges deferred a few specific matters for further discussion, including the calculation of Theoretical Price in the event a reliable NBBO is not available and the handling of erroneous complex orders and stock-option orders.⁶ The calculation of Theoretical Price is used in determining whether an options transaction is potentially erroneous and subject to a nullification or adjustment under Rule 20.6.

B. Calculation of Theoretical Price Using a Third Party Provider

Pursuant to Rule 20.6, when reviewing a transaction as potentially erroneous, the Exchange needs to first determine the “Theoretical Price” of the option, i.e., the Exchange’s estimate of the correct market price for the option. If the applicable option series is traded on at

⁴ See Securities Exchange Act Release No. 74556 (March 20, 2015), 80 FR 16031 (March 26, 2015) (order approving SR-BATS-2014-067); see also Securities and Exchange Act Release No. 73884 (December 18, 2014), 79 FR 77557 (December 24, 2014) (notice of filing of SR-BATS-2014-067).

⁵ See Notice, supra note 3, at 23684.

⁶ Since adopting the initial harmonized rule, the exchanges that offer complex orders and/or stock-option orders have addressed the handling of erroneous options transactions that result from the execution of complex orders and stock-option orders. See, e.g., Securities Exchange Act Release No. 80040 (February 14, 2017), 82 FR 11248 (February 21, 2017) (SR-CBOE-2016-088) (granting approval of a proposal related to the nullification and adjustment of erroneous complex order and stock-option order transactions).

least one other options exchange, then the Theoretical Price of an option series is generally the last national best bid (“NBB”) just prior to the trade in question with respect to an erroneous sell transaction or the last national best offer (“NBO”) just prior to the trade in question with respect to an erroneous buy transaction. However, there may be situations where the NBB or NBO is not available or may not be reliable. Specifically, under sub-paragraphs (b)(1)-(3) of Rule 20.6, these situations occur when there are no quotes or no valid quotes for comparison purposes, when the NBBO is determined to be too wide to be reliable, and at the open of each trading day. In each of these circumstances, because the NBB or NBO is not available or is deemed to be unreliable, the Exchange determines Theoretical Price.⁷ The Exchange notes that the process for determining Theoretical Price in such situations could be subjective and lead to disparate results for a transaction that spans multiple options exchanges.⁸

Accordingly, the Exchange proposes to adopt Interpretation and Policy .03 to Rule 20.6 to specify how the Exchange would determine Theoretical Price when required by sub-paragraphs (b)(1)-(3) of Rule 20.6.⁹ In particular, the Exchange worked with other options exchanges to identify and select a reliable third party vendor (“TP Provider”) that would provide Theoretical Price to the Exchange whenever one or more transactions is under review pursuant to

⁷ The Exchange states that when determining Theoretical Price under the current Rule, Exchange personnel generally consult and refer to data such as the prices of related series (especially the closest strikes in the option in question), the price of the underlying security, volatility characteristics of the option, and historical pricing of the option and/or similar options. See Notice, supra note 3, at 23685.

⁸ See id.

⁹ The Exchange has further proposed to modify paragraph (b) to Rule 20.6 to state that the Exchange will rely on paragraph (b) and Interpretation and Policy .03 when determining Theoretical Price.

Rule 20.6 and the NBBO is unavailable or deemed unreliable pursuant to Rule 20.6(b).¹⁰ The Exchange and other options exchanges selected CBOE Livevol, LLC (“Livevol”) as the TP Provider.¹¹ According to the Exchange, Livevol will develop a new tool in connection with this proposal based on its existing technology and services that would supply Theoretical Price to the Exchange and other options exchanges upon request.¹² Accordingly, pursuant to proposed Interpretation and Policy .03 of Rule 20.6, when the Exchange must determine Theoretical Price pursuant to sub-paragraphs (b)(1)-(3) of Rule 20.6, the Exchange would request Theoretical Price from the same TP Provider as other options exchanges that have adopted the new harmonized provision in their rules.¹³

In addition, the Exchange proposes that if an Official¹⁴ of the Exchange believes that the Theoretical Price provided by the TP Provider is fundamentally incorrect and cannot be used consistent with the maintenance of a fair and orderly market, the Official shall contact the TP Provider to notify the TP Provider of the reason the Official believes such Theoretical Price is inaccurate and to request a review and correction of the calculated Theoretical Price.¹⁵ The

¹⁰ See Notice, supra note 3, at 23685.

¹¹ See id. The Exchange proposes to codify the selection of Livevol in proposed paragraph (d) to Interpretation and Policy .03 of Rule 20.6. See id.

¹² See id. The Exchange states that the Theoretical Price tool would leverage current market data and surrounding strikes to assist in a relative value pricing approach to generating a Theoretical Price. See id. When relative value methods are incapable of generating a valid Theoretical Price, the Theoretical Price tool will utilize historical trade and quote data to calculate Theoretical Price. See id.

¹³ See id.

¹⁴ For purposes of Rule 20.6, an Official is an Officer of the Exchange or such other employee designee of the Exchange that is trained in the application of Rule 20.6.

¹⁵ See proposed paragraph (b) to Interpretation and Policy .03 of Rule 20.6. If the TP Provider reviews the Theoretical Price, but disagrees that there has been any error, then

Exchange notes that it does not anticipate needing to rely on this provision frequently, if at all, but believes the provision would allow the Exchange to prepare for all potential circumstances.¹⁶

The Exchange has also proposed to promptly provide electronic notice to other options exchanges if the TP Provider has been contacted to review and correct the calculated Theoretical Price at issue and to include a brief explanation of the reason for the request.¹⁷

The Exchange also proposes that if the TP Provider experiences a systems issue that renders its services unavailable to accurately calculate Theoretical Price and such issue cannot be corrected in a timely manner, an Official of the Exchange may determine the Theoretical Price.¹⁸ The Exchange expects that it would await the TP Provider's services becoming available again if the Exchange was able to obtain information regarding the issue and the TP Provider had a reasonable expectation of being able to resume normal operations within the next several hours based on communications with the TP Provider.¹⁹ The Exchange also notes that if a wide-scale event occurred, even if such event did not qualify as a "Significant Market Event" pursuant to

the Exchange would be bound to use the Theoretical Price provided by the TP Provider. See Notice, supra note 3, at 23686 n.10.

¹⁶ See Notice, supra note 3, at 23686.

¹⁷ See proposed paragraph (b) to Interpretation and Policy .03 of Rule 20.6. According to the Exchange, it expects that all other options exchanges, once in receipt of this notification, would await the determination of the TP Provider and would use the corrected price as soon as it becomes available. See Notice, supra note 3, at 23686. The Exchange further notes that it expects the TP Provider to cooperate with, but to be independent of, the Exchange and other options exchanges. See id.

¹⁸ See proposed paragraph (c) to Interpretation and Policy .03 of Rule 20.6. The Exchange states that it does not anticipate needing to rely on this provision frequently, if at all, but believes the provision would allow the Exchange to prepare for all potential circumstances. See Notice, supra note 3, at 23686.

¹⁹ See Notice, supra note 3, at 23686. The Exchange states that Livevol has business continuity and disaster recovery procedures that would help to ensure that the Theoretical Price tool remains available or, in the event of an outage, that service is restored in a timely manner. See id.

Rule 20.6(e), and the TP Provider was unavailable or otherwise experiencing difficulty, the Exchange believes that it and other options exchanges would seek to coordinate to the extent possible.²⁰ In particular, the Exchange and other options exchanges have a process, administered by the Options Clearing Corporation, to invoke a discussion amongst all options exchanges in the event of any widespread or significant market events.²¹ The Exchange believes that this process could be used in the event necessary if there were an issue with the TP Provider.²²

The Exchange also proposes to adopt language in paragraph (d) of Interpretation and Policy .03 to Rule 20.6 to state that neither the Exchange, the TP Provider, nor any affiliate of the TP Provider, makes any warranty, express or implied, as to the results to be obtained by any person or entity from the use of the TP Provider pursuant to Interpretation and Policy .03 to Rule 20.6. The proposed rule would further state that the TP Provider does not guarantee the accuracy or completeness of the calculated Theoretical Price and that the TP Provider disclaims all warranties of merchantability or fitness for a particular purpose or use with respect to such Theoretical Price. Finally, proposed paragraph (d) of Interpretation and Policy .03 to Rule 20.6 would state that neither the Exchange nor the TP Provider shall have any liability for any damages, claims, losses (including any indirect or consequential losses), expenses, or delays, whether direct or indirect, foreseen or unforeseen, suffered by any person arising out of any circumstance or occurrence relating to the use of such Theoretical Price or arising out of any errors or delays in calculating such Theoretical Price.²³

²⁰ See id.

²¹ See id.

²² See id.

²³ The Exchange states that proposed paragraph (d) of Interpretation and Policy .03 to Rule 20.6 is modeled after existing language in Exchange Rules regarding “reporting

C. No Valid Quotes – Market Participant Quoting on Multiple Exchanges

As described above, one of the times where the NBB or NBO is deemed to be unreliable for purposes of calculating the Theoretical Price is when there are no quotes or no valid quotes for the affected series. In addition to when there are no quotes, the Exchange does not consider the following to be valid quotes: (i) all quotes in the applicable option series published at a time where the last NBB is higher than the last NBO in such series; (ii) quotes published by the Exchange that were submitted by either party to the transaction in question; and (iii) quotes published by another options exchange against which the Exchange has declared self-help.²⁴

The Exchange proposes to add an additional category of invalid quotes in order to avoid a situation where a market participant has established the market at an erroneous price on multiple exchanges.²⁵ In particular, the Exchange proposes to also consider as invalid the quotes in a series published by another options exchange if either party to the transaction in question submitted the quotes in the series representing such options exchange's best bid or offer.²⁶ The Exchange, however, has proposed to only consider quotes invalid on other options exchanges in up to twenty-five total options series (i.e., whether such series all relate to the same underlying security or multiple underlying securities), which the Exchange states would allow it to apply the proposed rule in a timely and organized fashion.²⁷ The Exchange believes its proposal to limit

authorities" that calculate indices. See id. at 23687. See also, e.g., BZX Rule 29.13, which relates to index options potentially listed and traded on the Exchange and disclaims liability for a reporting authority and their affiliates.

²⁴ See Rule 20.6(b).

²⁵ See Notice, supra note 3, at 23687.

²⁶ See proposed Rule 20.6(b)(2)(C). The Exchange also proposes to renumber current Rule 20.6(b)(2)(C) as Rule 20.6(b)(2)(D).

²⁷ See Notice, supra note 3, at 23687.

the proposed rule to twenty-five total options series is necessary because the application of the proposal will take considerable coordination with other options exchanges to confirm that the quotations in question on an away options exchange were indeed submitted by a party to a transaction on the Exchange.²⁸ The Exchange also proposes to require the party that believes it established the best bid or offer on one or more other options exchanges to identify to the Exchange, in up to twenty-five total options series, the quotes which were submitted by such party and published by the other options exchanges.²⁹ In turn, the Exchange would verify with such other options exchanges that such quotations were indeed submitted by such party.³⁰

D. Trading Halts

Rule 20.3 describes the Exchange's authority to declare trading halts in one or more options traded on the Exchange. Currently, Rule 20.3 states that the Exchange shall nullify any transaction that occurs during a trading halt in the affected option on the Exchange or, with respect to equity options, during a trading halt on the primary listing market for the underlying security. The Exchange proposes to nullify any equity options transaction that occurs during a regulatory halt as declared by the primary listing market for the underlying security.³¹ The Exchange believes this change is necessary to distinguish a declared regulatory halt, where the underlying security should not be actively trading on any venue, from an operational issue on the primary listing exchange where the security continues to safely trade on other trading venues.³²

²⁸ See id.

²⁹ See id. at 23688.

³⁰ See id.

³¹ See proposed paragraph (b) of Interpretation and Policy .01 to Rule 20.3.

³² See Notice, supra note 3, at 23688.

E. Implementation Date

In order to ensure that other options exchanges are able to adopt rules consistent with this proposal and to coordinate the effectiveness of such harmonized rules, the Exchange proposes to delay the effectiveness of this proposal to a date within ninety days following this approval.³³

III. Discussion and Commission Findings

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.³⁴ In particular, the Commission finds that the proposed rule change is consistent with the requirements of Section 6(b) of the Act³⁵ and with Section 6(b)(5) of the Act,³⁶ which requires, among other things, that the Exchange's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Commission believes that the proposal to amend Rule 20.6 will help assure greater objectivity, transparency, and clarity with respect to the adjustment and nullification of erroneous options transactions. The Commission notes that the proposal is designed to achieve more consistent results for participants across U.S. options exchanges than under the initial harmonized rules, while maintaining a fair and orderly market, protecting investors, and

³³ See id. The Exchange will announce the operative date in a Regulatory Circular made available to its Members. See id.

³⁴ In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

³⁵ 15 U.S.C. 78f(b).

³⁶ 15 U.S.C. 78f(b)(5).

protecting the public interest. In particular, the proposal is designed to increase the consistency and transparency in the handling of erroneous options transactions in situations where the NBBO is unavailable or deemed unreliable pursuant to Rule 20.6(b).

The Commission also believes that the Exchange's proposed change to its no valid quotes provision, as described in greater detail above, is consistent with the Act and would further the goal of providing increased transparency and uniformity in the handling of erroneous options transactions in a timely and organized fashion. Finally, the Commission believes that the Exchange's proposed change to Rule 20.3 would provide increased transparency to its trading halt rule.

Based on the foregoing, the Commission believes that the proposed rule change is consistent with Section 6(b)(5) of the Act³⁷ in that proposed Rules 20.3 and 20.6 will foster cooperation and coordination with persons engaged in regulating and facilitating transactions.

The Commission notes that the proposed rule change will become operative within ninety days following its approval, on a date to be announced in a Regulatory Circular made available by the Exchange to its Members. This delayed implementation is to ensure that other options exchanges will have sufficient time to adopt rules consistent with this proposal and to coordinate the date of implementation of such harmonized rules.³⁸

³⁷ 15 U.S.C. 78f(b)(5).

³⁸ See Notice, supra note 3, at 23688.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³⁹ that the proposed rule change (SR-BatsBZX-2017-35) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁴⁰

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Assistant Secretary

³⁹ 15 U.S.C. 78s(b)(2).

⁴⁰ 17 CFR 200.30-3(a)(12).