

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-87340; File No. SR-CBOE-2019-048)

October 17, 2019

Self-Regulatory Organizations; Cboe Exchange, Inc.; Order Approving on an Accelerated Basis a Proposed Rule Change, as Modified by Amendment Nos. 2 and 3, to Adopt Rule 6.9 (In-Kind Exchange of Options Positions and ETF Shares)

I. Introduction

On September 6, 2019, 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 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to adopt Rule 6.9. The proposed rule change was published for comment in the Federal Register on September 25, 2019.³ On September 27, 2019, the Exchange filed Amendment No. 1 to the proposed rule change. On October 2, 2019, the Exchange withdrew Amendment No. 1 and filed Amendment No. 2 to the proposed rule change.⁴ On October 7, 2019, the Exchange filed

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 87013 (September 19, 2019), 84 FR 50490 (“Notice”).

⁴ In Amendment No. 2, the Exchange clarifies: (1) in its description of the proposal that the transfer price(s) of the options would be the price(s) used to calculate the net asset value (“NAV”) of the exchange-traded fund (“ETF”) shares, in conformance with the proposed rule text; and (2) its expectation regarding the magnitude of the transfers pursuant to the proposed rule, asserting that it would constitute a minimal percentage of the total average daily volume of the combined standardized and FLEXible EXchange Options (“FLEX Options”) with the same underlying security or index (rather than simply stating that it would constitute a minimal percentage of average daily volume of options). Amendment No. 2 does not materially alter the substance of the proposed rule change or raise unique or novel regulatory issues, and therefore it is not subject to notice and comment. Amendment No. 2 to the proposed rule change is available at: <https://www.sec.gov/comments/sr-cboe-2019-048/srcboe2019048-6283760-193330.pdf>.

Amendment No. 3 to the proposed rule change.⁵ The Commission received one comment on the proposed rule change.⁶ The Commission is approving the proposed rule change, as modified by Amendment Nos. 2 and 3, on an accelerated basis.

II. Summary of the Proposed Rule Change

A. Background

Specified quantities of ETF shares are created and redeemed for consideration by authorized participants. “In-kind” creations and redemptions occur when the authorized participants present (in the case of creations) or receive (in the case of redemptions) securities in exchange for ETF shares. The Commission has observed that, when creation and redemption transactions occur wholly or partly in-kind, certain benefits can accrue to an ETF and its investors; specifically, in-kind exchanges generally result in: (1) lower trading expenses (because securities received or delivered in-kind do not need to be purchased or sold in the market by the ETF, thus avoiding brokerage fees); and (2) lower taxable gains to shareholders (because appreciated securities are not sold but are delivered in kind to redeeming authorized participants).⁷

⁵ In Amendment No. 3, the Exchange revises the proposed rule text to renumber proposed Rule 6.49C to Rule 6.9 and correct an internal cross-reference to newly renumbered Rule 5.12 in order to conform the proposal to rule text organizational changes that became effective pursuant to a separate proposed rule change while the instant proposal was pending before the Commission. Because Amendment No. 3 is a technical amendment that does not materially alter the substance of the proposed rule change or raise unique or novel regulatory issues, it is not subject to notice and comment. Amendment No. 3 to the proposed rule change is available at: <https://www.sec.gov/comments/sr-cboe-2019-048/srcboe2019048-6258834-192936.pdf>.

⁶ See letter dated October 11, 2019 from Ken Mungan, Chairman, Milliman Financial Risk Management LLC, to Vanessa Countryman, Secretary, Commission (“Comment Letter”), which is available at: <https://www.sec.gov/comments/sr-cboe-2019-048/srcboe2019048-6285127-193334.pdf>.

⁷ See Securities Exchange Act Release No. 75165 (June 12, 2015), 80 FR 34729, 34732-33 (June 17, 2015) (requesting comment on topics related to the listing and trading of

The Exchange's current rules do not allow its Trading Permit Holders to effect options transfers in connection with ETF creations or redemptions because such transfers do not occur on Cboe or on another national securities exchange. Specifically, Cboe Rule 5.12(a)⁸ generally requires that transactions by Trading Permit Holders in option contracts listed on the Exchange for a premium in excess of \$1.00 must be effected on the Exchange or on another national securities exchange.⁹

B. Proposed Rule 6.9

The Exchange proposes to adopt Rule 6.9, which would add a new circumstance under which off-floor transfers of options positions by Trading Permit Holders would be allowed. Under proposed Rule 6.9, positions in options listed on the Exchange would be permitted to be transferred off the Exchange by a Trading Permit Holder in connection with transactions to purchase or redeem "creation units" of ETF shares between an "authorized participant"¹⁰ and the

exchange-traded products on national securities exchanges and sales of these products by broker-dealers).

⁸ See Amendment No. 3, supra note 5 (describing the relocation of this rule to its current location in the Cboe rulebook).

⁹ Cboe Rule 6.7(a) lists the circumstances under which Trading Permit Holders may transfer their positions off of the Exchange. The circumstances listed include: (1) the dissolution of a joint account in which the remaining Trading Permit Holder assumes the positions of the joint account; (2) the dissolution of a corporation or partnership in which a former nominee of the corporation or partnership assumes the positions; (3) positions transferred as part of a Trading Permit Holder's capital contribution to a new joint account, partnership, or corporation; (4) the donation of positions to a not-for-profit corporation; (5) the transfer of positions to a minor under the Uniform Gifts to Minors Act; and (6) a merger or acquisition where continuity of ownership or management results. Additionally, Cboe Rule 5.12(b) allows a Trading Permit Holder acting as agent to execute a customer's order off the Exchange floor with any other person (except when such Trading Permit Holder also is acting as agent for such other person in such transaction) for the purchase or sale of an option contract listed on the Exchange.

¹⁰ For purposes of proposed Rule 6.9, an "authorized participant" is an entity that has a written agreement with the issuer of ETF shares or one of its service providers, which

issuer¹¹ of such ETF shares, which transfer would occur at the price used to calculate the NAV of such ETF shares.

The Exchange asserts that proposed Rule 6.9: (1) would allow options-based ETFs to be more tax-efficient investment vehicles, to the benefit of their shareholders; and (2) may result in transaction cost savings for such ETFs, which may be passed along to investors.¹² The Exchange states that, while information regarding options transactions effected on the Exchange is disseminated to OPRA, information regarding transferred options positions such as those that would occur pursuant to the proposed rule is not disseminated to OPRA and is not otherwise publicly available.¹³ Nevertheless, the Exchange asserts that price discovery and transparency for Exchange-listed options would not be compromised under proposed Rule 6.9. The Exchange notes that, in conjunction with the creation and redemption process, positions would be transferred at price(s) used to calculate the NAV of the ETF shares.¹⁴ The Exchange further states that any transfers effected pursuant to the proposed rule would constitute a minimal percentage of the total average daily volume of the combined standardized and FLEX Options with the same underlying security or index.¹⁵ Further, the Exchange generally expects creations

allows the authorized participant to place orders for the purchase and redemption of creation units (i.e., specified quantities of ETF shares).

¹¹ For purposes of proposed Rule 6.9, an issuer of ETF shares would be registered with the Commission as an open-end management investment company under the Investment Company Act of 1940.

¹² See Notice, supra note 3, 84 FR at 50491.

¹³ See id. at 50493.

¹⁴ See Amendment No. 2, supra note 4.

¹⁵ See id.

or redemptions to include corresponding transactions by the authorized participant that will occur on an exchange and be reported to OPRA.¹⁶

C. Comment Letter

The Commission received one comment letter, and the commenter supports Cboe's proposal. The commenter states that Cboe's current rules do not permit off-floor transfers for an equal value of shares of an ETF. As a result, only equity- and bond-based ETFs may utilize the in-kind redemption process, which provides tax efficiency.¹⁷ The commenter asserts that, by helping to improve the tax efficiency of ETFs that hold options, the proposal would establish a level for options-based ETFs and thereby increase the choices available to investors, including allowing more investors to access investment strategies previously available only to institutions and high net worth individuals.¹⁸

III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change, as modified by Amendment Nos. 2 and 3, is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange.¹⁹ Specifically, the Exchange finds that the proposed rule change is consistent with Section 6(b)(5)²⁰ of the Act, which requires (among other things)

¹⁶ The Exchange states that: (1) for in-kind creations, an authorized participant will acquire the necessary options positions in an on-exchange transaction that will be reported to OPRA; and (2) for in-kind redemptions, it expects that an authorized participant will acquire both the shares necessary to effect the redemption and an options position to offset the position that it will receive as proceeds for the redemption, and that such options position likely would be acquired in an on-exchange transaction that would be reported to OPRA. See Notice, supra note 3, 84 FR at 50493, n.16.

¹⁷ See Comment Letter, supra note 6, at 2.

¹⁸ See id.

¹⁹ 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).

²⁰ 15 U.S.C. 78f(b)(5).

that the rules of an exchange 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 proposed Rule 6.9 is designed to protect investors and the public interest because it should facilitate in-kind creations and redemptions by options-based ETFs, which should lower taxable gains of shareholders of such ETFs. The Commission further believes that, by facilitating in-kind creations and redemptions by options-based ETFs, the proposed rule may also lower such funds' transaction costs.

In support of this proposal, the Exchange has made the following representations:

1. OCC has informed the Exchange that it has the operational capabilities to effect the proposed position transfers.²¹
2. All transfers pursuant to proposed Rule 6.9 would be required to comply with OCC rules.²²

This approval order is based on all of the Exchange's statements and representations, including those set forth above, in the Notice, and in Amendment No. 2.

For the foregoing reasons, the Commission finds that the proposed rule change, as modified by Amendment Nos. 2 and 3, is consistent with the Act²³ and the rules and regulations thereunder applicable to a national securities exchange.

²¹ See Notice, supra note 3, 84 FR at 50493, n.14.

²² See id.

²³ 15 U.S.C. 78f(b)(5).

IV. Accelerated Approval of the Proposed Rule Change, as Modified by Amendment Nos. 2 and 3

The Commission finds good cause to approve the proposed rule change, as modified by Amendment Nos. 2 and 3, prior to the thirtieth day after the date of publication of the Notice in the Federal Register. The Exchange represents that October 31, 2019 is the fiscal year end for certain options-based ETFs whose shares are listed on Cboe BZX Exchange, Inc. and that, if such ETFs transition to in-kind transactions by the end of their fiscal year, their shareholders would no longer be subject to taxable distributions. The Exchange further represents that the funds and their authorized participants require time to implement the transition to in-kind creations and redemptions. The potential for tax savings for options-based ETF shareholders constitutes good cause to approve the proposal on an accelerated basis. The Commission also notes that, during the 21-day comment period after the Notice was published in the Federal Register, the only comment received supports the proposal.²⁴

²⁴ See supra section II.C.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁵ that the proposed rule change (SR-CBOE-2019-048), as modified by Amendment Nos. 2 and 3, be, and it hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁶

Jill M. Peterson
Assistant Secretary

²⁵ 15 U.S.C. 78s(b)(2).

²⁶ 17 CFR 200.30-3(a)(12).