

September 20, 2023

Self-Regulatory Organizations; Cboe Exchange, Inc.; Order Granting Approval of a Proposed Rule Change to Make Permanent the Operation of its Pilot Program that Allows the Exchange to List P.M.-Settled Third Friday-of-the-Month Mini-SPX Index (“XSP”) Options and Mini-Russell 2000 Index (“MRUT”) Options Series

I. Introduction

On April 19, 2023, Cboe Exchange, Inc. (“Exchange” or “Cboe Options”) 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 make permanent the operation of its pilot program (“Program”) that permits the Exchange to list p.m.-settled third Friday-of-the-month XSP and MRUT options (“p.m.-settled XSP” and “p.m.-settled MRUT,” respectively, and collectively, the “Pilot Products”). The proposed rule change was published for comment in the Federal Register on April 28, 2023.³ On June 9, 2023, pursuant to Section 19(b)(2) of the Act,⁴ 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.⁵ On July 27, 2023, the Commission instituted proceedings to determine whether to approve or disapprove the proposed rule change.⁶ The Commission did not receive any comment letters and is approving

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 97366 (April 24, 2023), 88 FR 26359 (“Notice”).

⁴ 15 U.S.C. 78s(b)(2).

⁵ See Securities Exchange Act Release No. 97678, 88 FR 39285 (June 15, 2023). The Commission designated July 27, 2023, as the date by which the Commission shall approve or disapprove, or institute proceedings to determine whether to approve or disapprove, the proposed rule change.

⁶ See Securities Exchange Act Release No. 98005, 88 FR 50943 (August 2, 2023).

the proposed rule change.

II. Background

When cash-settled⁷ index options were first introduced in the 1980s, they generally utilized closing-price settlement procedures (i.e., p.m. settlement).⁸ The Commission became concerned with the impact of p.m.-settled, cash-settled index options on the underlying cash equities markets, and in particular, added market volatility and sharp price movements near the close on expiration days.⁹ These concerns were heightened during the “triple-witching” hour on the third Friday of March, June, September, and December when index options, index futures, and options on index futures expired concurrently.¹⁰ Academic research at the time provided at least some evidence suggesting that futures and options expirations contributed to excess volatility and reversals around the close on those days.¹¹

In light of the concerns with p.m. settlement and to help ameliorate the price effects associated with expirations of p.m.-settled, cash-settled index products, in 1987, the Commodity

⁷ The seller of a “cash-settled” index option pays out the cash value of the applicable index on expiration or exercise. A “physical delivery” option, like equity and ETF options, involves the transfer of the underlying asset rather than cash. See Characteristics and Risks of Standardized Options, available at: <https://www.theocc.com/Company-Information/Documents-and-Archives/Options-Disclosure-Document>.

⁸ See Securities Exchange Act Release No. 65256 (September 2, 2011), 76 FR 55969, at 55972 (September 9, 2011) (SR-C2-2011-008) (Order approving proposed rule change to establish a pilot program to list and trade p.m.-settled third Friday-of-the-month S&P 500 stock index (“SPX”) options (“SPXPM”) on the C2 Options Exchange, Incorporated (“C2”)) (“C2 SPXPM Approval”). SPXPM was traded on a pilot basis on C2 until the introduction of SPXPM trading on Cboe Options. See Securities Exchange Act Release No. 68888 (February 8, 2013), 78 FR 10668, at 10668 (February 14, 2013) (SR-CBOE-2012-120) (“SPXPM Approval Order”).

⁹ See C2 SPXPM Approval, 76 FR at 55972.

¹⁰ See id.

¹¹ See Securities and Exchange Commission, Division of Economic Risk and Analysis, Memorandum dated February 2, 2021 on Cornerstone Analysis of PM Cash-Settled Index Option Pilots (September 16, 2020) (“Pilot Memo”) at 5, available at: https://www.sec.gov/files/Analysis_of_PM_Cash_Setled_Index_Option_Pilots.pdf (citing, among other papers, Stoll, Hans R., and Robert E. Whaley, “Expiration day effects of index options and futures,” Monograph Series in Finance and Economics, no. 3 (1986)).

Futures Trading Commission approved a proposed rule change by the Chicago Mercantile Exchange (“CME”) to provide for a.m. settlement¹² for index futures, including futures on the S&P 500 Index (“S&P 500”).¹³ The Commission subsequently approved a proposed rule change by Cboe Options to list and trade a.m.-settled options on the S&P 500.¹⁴ In 1992, the Commission approved Cboe Options’ proposal to transition all of its European-style cash-settled options on the S&P 500 to a.m. settlement.¹⁵ However, in 1993, the Commission approved a proposed rule change allowing Cboe Options to list p.m.-settled options on certain broad-based indexes, including the S&P 500, expiring at the end of each calendar quarter (since approved as permanent).¹⁶ Starting in 2006, the Commission approved a number of proposals, on a pilot basis, permitting Cboe Options to introduce other index options, including SPX options, with p.m.-settlement. These include p.m.-settled index options expiring weekly (other than the third Friday) and at the end of each month,¹⁷ SPXPM, as well as p.m.-settled XSP and MRUT options

¹² The exercise settlement value for an a.m.-settled index option is determined by reference to the reported level of the index as derived from the opening prices of the component securities on the business day before expiration.

¹³ See Proposed Amendments Relating to the Standard and Poor’s 500, the Standard and Poor’s 100 and the Standard Poor’s OTC Stock Price Index Futures Contract, 51 FR 47053 (December 30, 1986) (notice of proposed rule change from the CME). See also Securities Exchange Act Release No. 24367 (April 17, 1987), 52 FR 13890 (April 27, 1987) (SR-CBOE-87-11) (noting that the CME moved the S&P 500 futures contract’s settlement value to opening prices on the delivery date).

¹⁴ See Securities Exchange Act Release No. 24367 (April 17, 1987), 52 FR 13890 (April 27, 1987) (SR-CBOE-87-11).

¹⁵ See Securities Exchange Act Release No. 30944 (July 21, 1992), 57 FR 33376 (July 28, 1992) (SR-CBOE-92-09). The Commission also approved proposals by other options markets to transfer most of their cash-settled index products to a.m. settlement. See, e.g., Securities Exchange Act Release No. 25804 (June 15, 1988), 53 FR 23475 (June 22, 1988) (SR-NYSE-87-11 and 88-04).

¹⁶ See Securities Exchange Act Release No. 31800 (February 1, 1993), 58 FR 7274 (February 5, 1993) (SR-CBOE-92-13). See also Securities Exchange Act Release Nos. 54123 (July 11, 2006), 71 FR 40558 (July 17, 2006) (SR-CBOE-2006-65); and 60164 (June 23, 2009), 74 FR 31333 (June 30, 2009) (SR-CBOE-2009-029).

¹⁷ See Securities Exchange Act Release Nos. 62911 (September 14, 2010), 75 FR 57539 (September 21, 2010) (SR-CBOE-2009-075); 76529 (November 30, 2015), 80 FR 75695 (December 3, 2015) (SR-CBOE-2015-106); and 78531 (August 10, 2016), 81 FR 54643 (August 16, 2016) (SR-CBOE-2016-046).

expiring on the third Friday of the month.¹⁸

In the course of approving the various pilots, the Commission reiterated its concern about the potential impact on the market at expiration for the underlying component stocks for a p.m.-settled, cash-settled index option.¹⁹ However, the Commission also recognized the potential impact was unclear.²⁰ The Commission approved the Program on a pilot basis to allow the Exchange and the Commission to monitor for and assess any potential for adverse market effects.²¹ In order to facilitate this assessment, the Exchange committed to provide the Commission with data and analysis in connection with the Program²² and to make such data publicly available.²³ In addition to the Exchange's data and analysis, Cornerstone Research also conducted an analysis at the direction of Staff from the Commission's Division of Economic and Risk Analysis. The analysis utilizes the level of expiring p.m.-settled index options open interest and the measures of volatility and price reversals for the corresponding index futures, the underlying cash index, and index component securities in the minutes leading up to and immediately following the market close to study the effects of pilot programs allowing p.m.-settled index options. The Pilot Memo is discussed in more detail below.

¹⁸ See Securities Exchange Act Release Nos. 70087 (July 31, 2013), 78 FR 47809 (August 6, 2013) (SR-CBOE-2013-055) ("XSP Approval Order"); and 91067 (February 5, 2021) 86 FR 9108 (February 11, 2021) (SR-CBOE-2020-116) ("MRUT Approval Order").

¹⁹ See, e.g., SPXPM Approval Order, 78 FR at 10669. See also Securities Exchange Act Release Nos. 64599 (June 3, 2011), 76 FR 33798, 33801-02 (June 9, 2011) (order instituting proceedings to determine whether to approve or disapprove a proposed rule change to allow the listing and trading of SPXPM options on the C2 Options Exchange, Incorporated); and C2 SPXPM Approval, 76 FR at 55972-76.

²⁰ See, e.g., SPXPM Approval Order, 78 FR at 10669.

²¹ See XSP Approval Order, 78 FR at 47811; and MRUT Approval Order, 86 FR at 9109.

²² Id.

²³ See, e.g., Securities Exchange Act Release No. 97446 (May 5, 2023), 88 FR 30365, at 30366 (May 11, 2023) (SR-CBOE-2023-024) (stating the Exchange is making public on its website data and analyses previously submitted to the Commission under the Program and committing to make public any data or analyses submitted in the future).

III. Description of the Proposal

The Pilot Products are cash-settled options with third Friday-of-the-month expiration dates (“Expiration Friday”) whose exercise settlement value is derived from closing prices on the last trading day prior to expiration.

The Exchange has filed to extend the operation of the pilot on multiple occasions²⁴ and it is currently set to expire on the earlier of November 6, 2023, or the date on which the Program is approved on a permanent basis.²⁵ Now, the Exchange proposes to make the Program permanent.

Since the Program’s inception in 2013 for p.m.-settled XSP and 2021 for p.m.-settled MRUT, the Exchange has submitted reports to the Commission regarding the Program that detail the Exchange’s experience with the Program, pursuant to the XSP and MRUT Approval Orders.²⁶ The Exchange states that, during the course of the Program, it also provided the Commission with any additional data or analyses the Commission requested if the Commission deemed such data or analyses necessary to determine whether the Program was consistent with the Act.²⁷

IV. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to a national securities

²⁴ See, e.g., Securities Exchange Act Release Nos. 71424 (January 28, 2014), 79 FR 6249 (February 3, 2014) (SR-CBOE-2014-004) and 96222 (November 3, 2022), 87 FR 67736 (November 9, 2022) (SR-CBOE-2022-054).

²⁵ See Securities Exchange Act Release No. 97446 (May 5, 2023), 88 FR 30365 (May 11, 2023).

²⁶ See *supra* note 18. The Exchange has made public on its website data and analyses previously submitted to the Commission under the Program. See <https://www.cboe.com/aboutcboe/legal-regulatory/national-market-system-plans/pm-settlement-spxpm-data>.

²⁷ See Notice, 88 FR at 26361-26362.

exchange.²⁸ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,²⁹ 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. In its proposal to make the Program permanent, the Exchange addressed whether the Program negatively impacts markets or impacted the quality of the XSP and MRUT options market. Each of these elements is discussed in greater detail below. As stated above, no comments were received on the proposed rule change.

Market Impact Considerations

The Exchange states it has not identified any evidence from the pilot data indicating that the trading of the Pilot Products has any adverse impact on fair and orderly markets on Expiration Fridays for the Mini-SPX Index, the Mini-RUT Index or the underlying securities comprising the underlying indexes, nor have there been any observations of abnormal market movements attributable to the Pilot Products from any market participants that have come to the attention of the Exchange.³⁰ In order to support its overall assessment of the Program, the Exchange included a review and analysis of pilot data.³¹ Among other things, the Exchange's analysis includes end of day volatility as well as a comparison of the impact of quarterly index

²⁸ 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).

²⁹ 15 U.S.C. 78f(b)(5).

³⁰ See Notice, 88 FR at 26362.

³¹ See id. at 26361-65. The Exchange states that although its analysis specifically evaluated SPX options, the Exchange believes it is appropriate to extrapolate the data to apply the Pilot Products. See Notice, 88 FR at 26365. The Commission agrees it is appropriate to extrapolate the data to the Pilot Products, as the Exchange's analysis examines liquidity and volatility dynamics around the market close, which may be associated with typical hedging activities tied to expiring p.m.-settled index options.

rebalancing versus p.m.-settled expirations.³²

In addition to reviewing the data and analysis provided by the Exchange, the Commission reviewed the analysis in the Pilot Memo, which evaluates whether higher levels of expiring open interest in p.m.-settled index options results in increased volatility and price reversals around the close. The Pilot Memo shows that the market share for p.m.-settled options on the S&P 500 has grown substantially since 2007.³³ The Exchange's review of pilot data also showed this trend continuing from 2019 through 2021.³⁴

The Pilot Memo examines whether and to what extent expiring open interest in p.m.-settled index options is empirically related with the tendency of the corresponding index futures, the underlying index, or index components to experience increased transitory volatility and price reversals around the time of market close on expiration dates. The Pilot Memo concludes that, although expiring p.m.-settled index option open interest may have a statistically significant relationship with volatility and price reversals of the underlying index, index futures, and index component securities around the market close, the magnitude of the effect is economically very small.³⁵ For example, the largest settlement event that occurred during the time period studied in the Pilot Memo (a settlement of \$100.4 billion of notional on December 29, 2017) had an estimated impact on the futures price of only approximately 0.02% (a predicted impact of \$0.54 relative to a closing futures price of \$2,677).³⁶

³² See id. at 26364.

³³ See Pilot Memo at 2.

³⁴ See Notice, 88 FR at 26362. Specifically, since 2007, p.m.-settled SPX options grew from 0.1% of open interest to 30% of open interest in 2021. Id.

³⁵ See Pilot Memo at 3. The Pilot Memo also examined options on the Russell 2000 Index and the Nasdaq-100 Index. However, during the time period covered by the study (2007-2018), the markets for both a.m.- and p.m.-settled options on these indexes were very small compared to the size of that for S&P 500 Index options. See id. at 4.

³⁶ See id. at 3.

The Exchange further reviewed a sample of pilot data from 2019 through 2021, and measured the volatility of the S&P 500 over the final fifteen minutes of each trading day and compared expiration days to non-expiration days.³⁷ Generally volatility was slightly higher on expiration days, but in cases where overall market volatility increased, the normalized impact on expiration days versus non-expiration days remained consistent.³⁸ The Exchange further analyzed volatility on days when the S&P 500 was rebalanced, and states its results suggest more closing volatility on rebalance dates compared to non-rebalance expiration dates, indicating that rebalancing of the S&P 500 may have a greater impact on S&P 500 volatility than p.m.-settled option expirations.³⁹

The Exchange also reviewed a sample of post-2018 pilot data for potential correlation between excess market volatility and price reversals and the hedging activity of liquidity providers.⁴⁰ To determine whether there is a correlation, the Exchange calculated an estimate of the amount of market-on-close (“MOC”) volume in the S&P 500 component markets attributable to expected hedging activity as a result of expiring in-the-money options.⁴¹ The Exchange states its results indicate that other sources of MOC share volume generally exceed the volume resulting from hedging activity for p.m.-settled SPX options.⁴² Further, the Exchange also compared hedging futures positions that would correspond to expiring in-the-money p.m.-settled SPX options and concludes the data indicate negligible capacity for hedging

³⁷ See Notice, 88 FR at 26363.

³⁸ See id.

³⁹ See id.

⁴⁰ See id.

⁴¹ See id.

⁴² See id. at 26364.

activity to increase volatility in the underlying markets.⁴³

Finally, the Exchange states that the significant changes in the closing procedures of the primary markets in recent decades, including considerable advances in trading systems and technology, have significantly minimized risks of any potential impact of p.m.-, cash-settled XSP or MRUT options on the underlying cash markets.⁴⁴

Market Quality Considerations

The Exchange also completed an analysis intended to evaluate whether the Program impacted the quality of the a.m.-settled options market. Specifically, the Exchange compared values of key market quality indicators (specifically, the bid-ask spread⁴⁵ and effective spread⁴⁶) in p.m.-settled SPX weekly (“SPXW”) options both before and after the introduction of Tuesday expirations and Thursday expirations for SPXW options on April 18 and May 11, 2022, respectively.⁴⁷ The Exchange concludes from this analysis that the introduction of SPX options with Tuesday and Thursday options had no significant impact on the market quality of SPXW options with Monday, Wednesday, and Friday expirations.⁴⁸ For a majority of the series analyzed, the Exchange observed no statistically significant difference in bid-ask spread or

⁴³ See id.

⁴⁴ See id.

⁴⁵ The Exchange calculated for each of SPXW options (with Monday, Wednesday, and Friday expirations) and SPY Weekly options (with Monday, Wednesday, and Friday expirations) the daily time-weighted bid-ask spread on the Exchange during its regular trading hours session, adjusted for the difference in size between SPXW options and SPY options (SPXW options are approximately ten times the value of SPY options).

⁴⁶ The Exchange calculated the volume-weighted average daily effective spread for simple trades for each of SPXW options (with Monday, Wednesday, and Friday expirations) and SPY Weekly options (with Monday, Wednesday, and Friday expirations) as twice the amount of the absolute value of the difference between an order execution price and the midpoint of the national best bid and offer at the time of execution, adjusted for the difference in size between SPXW options and SPY options.

⁴⁷ For purposes of comparison, the Exchange paired SPXW options and SPY options with the same moneyness and same days to expiration.

⁴⁸ See Notice, 88 FR at 26364.

effective spread.⁴⁹ The Exchange states that analyzing whether the introduction of new SPXW p.m.-settled expirations (i.e., SPXW options with Tuesday and Thursday expirations) impacted the market quality of then-existing SPXW p.m.-settled expirations (i.e., SPXW options with Monday, Wednesday, and Friday expirations) provides a reasonable substitute to evaluate whether the introduction of p.m.-settled index options impacted market quality when the Program began.⁵⁰ Therefore, the Exchange believes the results of its analysis permit the Exchange to extrapolate that it is unlikely the introduction of p.m.-settled XSP or p.m.-settled MRUT options significantly impacted the market quality of a.m.-settled options, such as a.m.-settled SPX or Russell 2000 options, respectively, when the Program began.⁵¹

The Commission believes that the evidence contained in the Exchange's filing, the Exchange's pilot data and reports, and the Pilot Memo analysis demonstrate that the Program has benefitted investors and other market participants by providing more flexible trading and hedging opportunities while also having no disruptive impact on the market. The market for p.m.-settled options has grown in size over the course of the Program, and analysis of the pilot data did not identify any significant economic impact on the underlying component securities surrounding the close as a result of expiring p.m.-settled options nor did it indicate a deterioration in market quality (as measured by bid-ask and effective spreads) for an existing product when a new p.m.-settled expiration was introduced. Further, significant changes in closing procedures in the decades since index options moved to a.m. settlement may also serve to mitigate the potential impact of p.m.-settled index options on the underlying cash markets.

Accordingly, the Commission finds that the proposed rule change is consistent with

⁴⁹ See id.

⁵⁰ See Notice, 88 FR at 26364.

⁵¹ See id. at 26365.

Section 6(b)(5) of the Act⁵² and the rules and regulations thereunder applicable to a national securities exchange.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁵³ that the proposed rule change (SR-CBOE-2023-019) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁵⁴

Sherry R. Haywood,

Assistant Secretary.

⁵² 15 U.S.C. 78f(b)(5).

⁵³ 15 U.S.C. 78s(b)(2).

⁵⁴ 17 CFR 200.30-3(a)(12).