

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-83167; File No. SR-Phlx-2018-20)

May 3, 2018

Self-Regulatory Organizations; Nasdaq PHLX LLC; Order Approving a Proposed Rule Change Amending Rule 1079, FLEX Index, Equity and Currency Options, and Rule 1059, Accommodation Transactions, to Allow the Closing of Flexible Exchange Options (“FLEX options”) in Cabinet Trading

I. Introduction

On February 28, 2018, Nasdaq PHLX LLC (“Exchange” or “Phlx”) 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 amending Phlx’s Rule 1079, relating to FLEX Options, and Phlx Rule 1059, relating to accommodation transactions. The proposed rule change was published for comment in the Federal Register on March 19, 2018.³ The Commission received no comment letters on the proposed rule change. This order approves the proposed rule change.

II. Description of the Proposed Rule Change

The Exchange has proposed to amend Phlx Rule 1079, governing FLEX option transactions, and Phlx Rule 1059, governing accommodation transactions (also known as cabinet trades), to permit open FLEX positions to be closed pursuant to the cabinet procedures in Phlx Rule 1059.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 82866 (Mar. 13, 2018), 83 FR 12058 (Mar. 19, 2018) (“Notice”).

Phlx Rule 1079 permits the trading of FLEX options, which are options customized to fit specific investment strategies and goals.⁴ Further, Phlx Rule 1079(a)(4) requires that bids or offers in FLEX trades be made at the minimum increments specified in Phlx Rule 1034.⁵ Generally, the minimum increments for stock, index and exchange traded fund options are either \$.10 or \$.05, unless such options are subject to a penny pilot set forth in the rule.

Phlx Rule 1059 permits trading of cabinet orders, defined as closing limit orders at a price of \$1 per option contract for the account of a customer, firm, specialist or registered options trader⁶ (“ROT”).⁷ Thus, cabinet trades are generally effectuated at less than the minimum increments required for FLEX options, as described above, under the Phlx Rules 1079 and 1034. According to Phlx, cabinet trading is intended to accommodate persons wishing to effect closing transactions in options for which there is no auction market. Cabinet trading, according to the

⁴ See Phlx Rule 1079. See also Notice, supra note 3, at 12059. Pursuant to Phlx Rule 1079, investors can specify the characteristics for FLEX Option contracts such as the expiration date, the strike price, and the exercise-style.

⁵ Phlx Rule 1034 (a) provides that with certain exceptions, “all options on stocks, index options, and Exchange Traded Fund Shares quoting in decimals at \$3.00 or higher shall have a minimum increment of \$.10, and all options on stocks and index options quoting in decimals under \$3.00 shall have a minimum increment of \$.05.”

⁶ See Phlx Rule 1014(b). An ROT is a regular member or a foreign currency options participant of the Exchange located on the trading floor who has received permission from the Exchange to trade in options for his own account. Each ROT electing to engage in Exchange options transactions shall be assigned by the Exchange one or more classes of options, and Exchange options transactions initiated by such ROT on the Floor for any account in which he had an interest shall to the extent prescribed by the Exchange be in such assigned classes.

⁷ See Phlx Rule 1059(a). Commentary .02 to Phlx Rule 1059 provides that limit orders with a price of at least \$0 but less than \$1 per option contract may also trade under the terms and conditions in Phlx Rule 1059, subject to certain limitations.

Exchange, allows market participants to close listed options on the Exchange that are of minimal value or worthless, or not actively traded, often for the purpose of establishing tax losses.⁸

The Exchange has proposed to add Phlx Rule 1079(g) and Commentary .03 to Phlx Rule 1059 to state that open FLEX option positions are eligible to be closed in accordance with the minimum increments set forth in Phlx Rule 1059 governing cabinet trading.⁹ The Exchange further proposed that a FLEX option cabinet order may be executed against contra side interest that closes the FLEX option position or, to the extent permitted by the cabinet rule (specifically Phlx Rule 1059(a)(iii)), against contra side interest that opens a FLEX option position.¹⁰

Under existing Phlx rules all FLEX options are governed by the procedures for FLEX options in Phlx Rule 1079. To accommodate FLEX options trading as a cabinet order under Phlx Rule 1059, the Exchange also proposed in new Section 1079(g) that sections (a) and (b) of Phlx Rule 1079 would not apply to FLEX option transactions in the cabinet.¹¹ According to the Exchange, Phlx Rule 1079(a), which sets forth the potential characteristics of FLEX options, such as underlying interest and the quote format, would not be applicable for the closing of FLEX options in the cabinet because the characteristics of the FLEX options in the cabinet would already be known.¹² Further, Phlx stated that because FLEX options trading in the cabinet would be governed by the cabinet trading rules set forth in Phlx Rule 1059, except for the provisions of Phlx Rule 1079 noted below which will continue to apply, Phlx Rule 1079(b),

⁸ See Notice, supra note 3, at 12059 n.3. A cabinet trade is a transaction in which the per-contract value of the cabinet trade is less than the per-contract value of a trade at the specified minimum increment for the option contract. See id.

⁹ See proposed Phlx Rule 1079(g) and proposed Commentary .03 to Phlx Rule 1059.

¹⁰ See id. Phlx Rule 1059(a)(iii) provides that floor brokers would represent the orders in the crowd. See Phlx Rule 1059(a).

¹¹ See proposed Phlx Rule 1079(g) and proposed Commentary .03 to Phlx Rule 1059.

¹² See Notice, supra note 3, at 12059 n.6.

which covers procedures for quoting and trading FLEX options, and the provisions of Phlx Rule 1079(a) defining aspects of a FLEX request for the RFQ process, are not applicable.¹³

Under the Phlx's proposal, Phlx Rules 1079(c) – (f) would, however, continue to apply to FLEX option cabinet transactions.¹⁴ Phlx Rule 1079(c) restricts participation in FLEX cabinet trades to entities that meet the requirements set forth in this subsection,¹⁵ and Phlx Rules 1079(d) and (e) govern position limits and exercise limits.¹⁶

III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act¹⁷ and the rules and regulations thereunder applicable to a national securities exchange.¹⁸ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,¹⁹ which requires 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 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, in general, to protect investors and the public interest.

¹³ See id.

¹⁴ See proposed Phlx Rule 1079(g) and proposed Commentary .03 to Phlx Rule 1059.

¹⁵ See Phlx Rule 1079(c), which sets forth requirements for ROTs and specialists to be assigned to FLEX Options as well as financial requirements for floor brokers to trade FLEX Options.

¹⁶ See Notice, supra note 3, at 12059 n.6. Phlx Rule 1079(f) relates to the exercise-by-exception procedure of Rule 805 of the Options Clearing Corporation.

¹⁷ 15 U.S.C. 78f.

¹⁸ 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).

¹⁹ 15 U.S.C. 78f(b)(5).

The Commission believes that allowing the closing of FLEX options positions through cabinet trading is designed to promote just and equitable principles of trade and to remove impediments to and perfect the mechanism of a free and open market and a national market system by allowing market participants to close out their FLEX options positions that have little or no value prior to the options' expiration. Currently, market participants holding Phlx listed non-FLEX standardized options are allowed to close out positions with little or no value through an accommodation transaction known as a cabinet trade. FLEX option market participants currently do not have the same opportunity, despite the fact that there may be tax advantages to closing out a FLEX option position at a loss prior to the options expiration, and instead must hold the FLEX options until it expires, most likely worthless.²⁰ The Exchange also noted in its proposal that recently market participants have expressed an interest in closing FLEX options under the Phlx's cabinet rule.²¹ The proposed rule change, will therefore, provide market participants with an opportunity to liquidate FLEX option positions that are of minimal or no value prior to the FLEX options expiration, similar to that currently permitted by other market participants holding standardized options.

The Commission recognizes that the FLEX options market is unique in that it allows the customization of certain options terms between buyer and seller and that, as result, the FLEX options market does not typically have the liquidity and active trading market offered in the standardized options market. Despite these unique characteristics, however, allowing FLEX market participants to close out their FLEX options positions with little or no value in an

²⁰ As noted above, currently the FLEX rules do not permit Flex options to be traded as a cabinet order. Among other issues under the FLEX rules, the minimum size increments required under the FLEX rules essentially prohibit accommodation transactions in FLEX options.

²¹ See Notice, supra note 3, at 12059-60.

accommodation transaction under cabinet trading procedures, and subject to certain FLEX rules continuing to apply, would appear to be helpful to FLEX market participants.

Further, under the proposal, the existing Phlx rules concerning enhanced financial requirements and who may trade FLEX under Phlx Rule 1079 would continue to apply to any FLEX options executed under the cabinet trading rules. Any orders, whether a closing order or, as permitted, an opening order, executed against a Phlx FLEX option cabinet order are still therefore considered FLEX options orders, as indicated in the proposed changes to both Phlx Rules 1079 and 1059.

In addition, the position and exercise limits for FLEX options will continue to apply to FLEX options closed in the cabinet. The Commission notes, however, that under the FLEX rules equity options do not have position limits and positions in FLEX options are generally not aggregated with standardized options for position limit purposes, with some exceptions.²² The Commission expects Phlx to monitor FLEX cabinet orders to ensure that the lack of equity option position limits and aggregation with standardized positions do not present risks that would require the Exchange to impose additional margin as permitted under Phlx Rule 1079(d)(2) governing FLEX options. In addition, we request Phlx to monitor positions opened to accommodate a FLEX cabinet closing limit order to ensure that such open positions do not create any additional market risk that would need to be addressed through Phlx rules, such as requiring the aggregation of positions in standardized options with FLEX opening orders to accommodate a FLEX cabinet order. We would also expect Phlx to inform us generally of any other concerns that have arisen in allowing FLEX options to be executed under the cabinet trading rules.

²² See Phlx Rule 1079(d)(2)-(4).

For the reasons above, the Commission finds that the proposed rule change is consistent with the Act.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²³ that the proposed rule change (SR-Phlx-2018-20) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁴

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Assistant Secretary

²³ 15 U.S.C. 78s(b)(2).

²⁴ 17 CFR 200.30-3(a)(12).