

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-80040; File No. SR-CBOE-2016-088)

February 14, 2017

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Granting Approval of a Proposed Rule Change, as Modified by Amendment No. 1, Related to the Nullification and Adjustment of Options Transactions

I. Introduction

On December 14, 2016, Chicago Board Options Exchange, Incorporated (the “Exchange” or “CBOE”) 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 6.25, relating to the adjustment and nullification of erroneous complex order and stock-option order transactions. The proposed rule change was published for comment in the Federal Register on January 3, 2017.³ On February 13, 2017, the Exchange submitted Amendment No. 1 to the proposed rule change.⁴

The Commission received no comments regarding the proposal. This order approves the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 79697 (December 27, 2016), 82 FR 167 (“Notice”).

⁴ In Amendment No. 1, the Exchange proposed an implementation date of April 17, 2017, to allow all the other options exchanges that permit complex order or stock-option order transactions the time necessary to harmonize their obvious error rules with the proposed rule change. Because Amendment No. 1 does not materially alter the substance of the proposed rule change or raise unique or novel regulatory issues, Amendment No. 1 is not subject to notice and comment. To promote transparency of its proposed amendment, when CBOE filed Amendment No. 1 with the Commission, it also submitted Amendment No. 1 as a comment letter to the file, which the Commission posted on its website and placed in the public comment file for SR-CBOE-2016-088 (available at <https://www.sec.gov/comments/sr-cboe-2016-088/cboe2016088-1581994-131907.pdf>). The Exchange also posted a copy of its Amendment No. 1 on its website (<http://www.cboe.com/aboutcboe/legal/submittedsecfilings.aspx>), when it filed it with the Commission.

proposed rule change, as modified by Amendment No. 1.

II. Description of the Proposed Rule Change

The Exchange proposes to amend Rule 6.25, entitled “Nullification and Adjustment of Options Transactions” by adding Interpretation and Policy .07 (a)-(c) related to the adjustment and nullification of erroneous complex order and stock-option order transactions.

A. Background

The Exchange and other options exchanges previously adopted new, harmonized rules related to the adjustment and nullification of erroneous options transactions.⁵ The Exchange believes that the changes the options exchanges implemented with the new, harmonized rule have led to increased transparency and finality with respect to the adjustment and nullification of erroneous options transactions. However, as part of the initial initiative, the Exchange and other options exchanges deferred a few specific matters for further discussion, including how erroneous complex orders and stock-option orders should be handled.

Since the adopting of the initial harmonized rule, the exchanges that offer complex orders and/or stock-option orders discussed the adoption of a rule – described below – that they collectively believe will improve the handling of erroneous options transactions that result from the execution of complex orders and stock-option orders.⁶

⁵ See, e.g., Securities Exchange Act Release Nos. 74898 (May 7, 2015), 80 FR 27354 (May 13, 2015) (SR-CBOE-2015-039); and 74556 (March 20, 2015), 80 FR 16031 (March 26, 2015) (SR-BATS-2014-067) (“BATS Order”).

⁶ See Notice, supra note 3, at 167. An exchange that does not offer complex orders and/or stock-option orders will not adopt these new provisions until such time as the exchange offers complex orders and/or stock-option orders. See id. at 167 n.5.

B. Proposed Rule

The proposed rule applies much of the initial harmonized rule to complex orders and stock-option orders. The proposed rule, however, deviates from the initial harmonized rule to account for unique qualities of complex orders and stock-option orders. Specifically, the proposed rule reflects the fact that complex orders can execute against other complex orders or can execute against individual simple orders in the leg markets. When a complex order executes against the leg markets, there may be different counterparties on each leg of the complex order, and not every leg will necessarily be executed at an erroneous price. With regards to stock-option orders, the proposed rule reflects the fact that stock-option orders contain a stock component that is executed on a stock trading venue, and the Exchange may not be able to ensure that the stock trading venue will adjust or nullify the stock execution in the event of an obvious or catastrophic error. In order to account for the unique characteristics of complex orders and stock-option orders, the Exchange divided proposed Interpretation and Policy .07 into three parts—paragraphs (a), (b), and (c).

1. Complex Orders Executed against Individual Legs

Proposed Interpretation and Policy .07(a) governs the review of complex orders that are executed against individual legs (as opposed to a complex order that executes against another complex order).⁷ Proposed Rule 6.25.07(a) provides:

If a complex order executes against individual legs and at least one of the legs qualifies as an Obvious or Catastrophic Error under this Rule 6.25, then the leg(s) that is an Obvious or Catastrophic Error will be adjusted in accordance with paragraphs (c)(4)(A) or (d)(3), respectively, regardless of whether one of the parties is a Customer. However, any Customer order subject to this paragraph (a)

⁷ The leg market consists of quotes and/or orders in single options series. A complex order may be received by the Exchange electronically, and the legs of the complex order may have different counterparties.

will be nullified if the adjustment would result in an execution price higher (for buy transactions) or lower (for sell transactions) than the Customer's limit price on the complex order or individual leg(s). If any leg of a complex order is nullified, the entire transaction is nullified.

At least one of the legs of the complex order must qualify as an obvious or catastrophic error under the initial harmonized rule in order for the complex order to receive obvious or catastrophic error relief. Thus, when the Exchange is notified (within the timeframes set forth in paragraph (c)(2) or (d)(2)) of a complex order that is a possible obvious error or catastrophic error, the Exchange will first review the individual legs of the complex order to determine if one or more legs qualify as an obvious or catastrophic error.⁸ If no leg qualifies as an obvious or catastrophic error, the transaction stands—no adjustment and no nullification.

Reviewing the legs to determine whether one or more legs qualify as an obvious or catastrophic error requires the Exchange to follow the initial harmonized rule. In accordance with paragraphs (c)(1) and (d)(1) of the initial harmonized rule, the Exchange compares the execution price of each individual leg to the Theoretical Price⁹ of each leg (as determined by paragraph (b) of the initial harmonized rule). Under the proposed rule, if the execution price of an individual leg is higher or lower than the Theoretical Price for the series by an amount equal to at least the amount shown in the obvious error table in paragraph (c)(1) of the initial harmonized rule or the catastrophic error table in paragraph (d)(1) of the initial harmonized rule,

⁸ Because a complex order can execute against the leg market, the Exchange may also be notified of a possible obvious or catastrophic error by a counterparty that received an execution in an individual options series. If upon review of a potential obvious error the Exchange determines an individual options series was executed against the leg of a complex order or stock-option order, proposed Rule 6.25.07 will govern.

⁹ See Rule 6.25(b) (defining the manner in which Theoretical Price is determined).

the individual leg qualifies as an obvious or catastrophic error, and the Exchange will take steps to adjust or nullify the transaction.¹⁰

Paragraph (c)(4)(A) of the initial harmonized rule mandates that if it is determined that an obvious error has occurred, the execution price of the transaction will be adjusted pursuant to the table set forth in (c)(4)(A).¹¹ Although for simple orders paragraph (c)(4)(A) is only applicable when no party to the transaction is a Customer,¹² for the purposes of complex orders, paragraph (a) of proposed Interpretation and Policy .07 will supersede that limitation; therefore, if it is determined that a leg (or legs) of a complex order is an obvious error, the leg (or legs) will be adjusted pursuant to paragraph (c)(4)(A), regardless of whether a party to the transaction is a Customer. The Size Adjustment Modifier defined in subparagraph (a)(4) will similarly apply (regardless of whether a Customer is on the transaction) by virtue of the application of paragraph (c)(4)(A).¹³

Pursuant to proposed Rule 6.25.07(a), if a complex order executes against individual legs and at least one of the leg(s) qualifies as an Obvious Error or a Catastrophic Error, then the leg(s)

¹⁰ Only the execution price on the leg (or legs) that qualifies as an obvious or catastrophic error pursuant to any portion of proposed Rule 6.25.07 will be adjusted. The execution price of a leg (or legs) that does not qualify as an obvious or catastrophic error will not be adjusted.

¹¹ In contrast, paragraph (d)(3) of the initial harmonized rule mandates that if it is determined that a catastrophic error has occurred, the execution price of the transaction will be adjusted pursuant to the table set forth in paragraph (d)(3). However, if a Customer is a party to the transaction and the adjustment would result in an execution price higher (for buy transactions) or lower (for sell transactions) than the Customer's limit price, the Customer order will be nullified.

¹² See Rule 6.25(a)(1) (defining Customer for purposes of Rule 6.25 as not including a broker-dealer, Professional Customer, or Voluntary Professional Customer).

¹³ See Rule 6.25(c)(4)(A) (stating that any non-Customer Obvious Error exceeding 50 contracts will be subject to the Size Adjustment Modifier defined in sub-paragraph (a)(4)). The Size Adjustment Modifier may also apply to the option leg of a stock-option order that is adjusted pursuant to proposed Rule 6.25.07(c).

that is an Obvious or Catastrophic error will be adjusted in accordance with paragraphs (c)(4)(A) or (d)(3) of the initial harmonized rule, respectively, regardless of whether one of the parties is a Customer. However, because incoming complex orders may execute against resting simple orders in the leg market and adjusting the execution price of the leg may violate the limit price of the resting order, proposed Rule 6.25.07(a) also provides protection for Customer orders, stating that where at least one party to a complex order transaction is a Customer, the transaction will be nullified if adjustment would result in an execution price higher (for buy transactions) or lower (for sell transactions) than the Customer's limit price on the complex order or individual leg(s). If any leg of a complex order is nullified, the entire transaction will be nullified.

2. Complex Orders Executed Against Complex Orders

Proposed Interpretation and Policy .07(b) governs the review of complex orders that are executed against other complex orders. Proposed Rule 6.25.07(b) provides:

If a complex order executes against another complex order and at least one of the legs qualifies as an Obvious Error under paragraph (c)(1) or a Catastrophic Error under paragraph (d)(1), then the leg(s) that is an Obvious or Catastrophic Error will be adjusted or busted in accordance with paragraph (c)(4) or (d)(3), respectively, so long as either: (i) the width of the National Spread Market for the complex order strategy just prior to the erroneous transaction was equal to or greater than the amount set forth in the wide quote table of paragraph (b)(3) or (ii) the net execution price of the complex order is higher (lower) than the offer (bid) of the National Spread Market for the complex order strategy just prior to the erroneous transaction by an amount equal to at least the amount shown in the table in paragraph (c)(1). If any leg of a complex order is nullified, the entire transaction is nullified. For purposes of Rule 6.25, the National Spread Market for a complex order strategy is determined by the National Best Bid/Offer of the individual legs of the strategy.

As described above in relation to proposed Rule 6.25.07(a), the first step is for the Exchange to review (upon receipt of a timely notification in accordance with paragraph (c)(2) or (d)(2) of the initial harmonized rule) the individual legs to determine whether a leg or legs qualifies as an

obvious or catastrophic error. If no leg qualifies as an obvious or catastrophic error, the transaction stands—no adjustment and no nullification.

Unlike proposed Rule 6.25.07(a), the Exchange also proposes to compare the net execution price of the entire complex order package to the National Spread Market for the complex order strategy.¹⁴ Complex orders are exempt from the order protection rules of the options exchanges.¹⁵ Thus, depending on the manner in which the systems of an options exchange are calibrated, a complex order can execute without regard to the prices offered in the complex order books or the leg markets of other options exchanges. Accordingly, the Exchange proposes to consider the National Spread Market. Specifically, proposed Rule 6.25.07(b) provides that if the Exchange determines that a leg or legs does qualify as an obvious or catastrophic error, the leg or legs will be adjusted or busted in accordance with paragraph (c)(4) or (d)(3) of the initial harmonized rule, so long as either: (i) the width of the National Spread Market for the complex order strategy just prior to the erroneous transaction was equal to or greater than the amount set forth in the wide quote table of paragraph (b)(3) of the initial harmonized rule or (ii) the net execution price of the complex order is higher (lower) than the offer (bid) of the National Spread Market for the complex order strategy just prior to the erroneous transaction by an amount equal to at least the amount shown in the table in paragraph (c)(1) of the initial harmonized rule.

For purposes of complex orders that meet the requirements of proposed Rule 6.25.07(b), the Exchange proposes to apply the initial harmonized rule and adjust or bust obvious errors in

¹⁴ National Spread Market is the derived net market for a complex order package. See, e.g., Rule 6.53C.04 (utilizing the term derived net market in the context of complex order strategies).

¹⁵ See Rule 6.81(b)(7). All options exchanges have the same order protection rule.

accordance with paragraph (c)(4) (as opposed to applying only paragraph (c)(4)(A) as is the case under proposed Rule 6.25.07(a)) and catastrophic errors in accordance with paragraph (d)(3). Therefore, for purposes of complex orders under proposed Rule 6.25.07(b), if one of the legs is determined to be an obvious error under paragraph (c)(1), all Customer transactions will be nullified, unless a Trading Permit Holder (“TPH”) submits 200 or more Customer transactions for review in accordance with paragraph (c)(4)(C).¹⁶ For purposes of complex orders under proposed Rule 6.25.07(b), if one of the legs is determined to be a catastrophic error under paragraph (d)(3) and all of the other requirements of proposed Rule 6.25.07(b) are met, all market participants will be adjusted in accordance with the table set forth in paragraph (d)(3). Again, however, pursuant to paragraph (d)(3) where at least one party to a complex order transaction is a Customer, the transaction will be nullified if adjustment would result in an execution price higher (for buy transactions) or lower (for sell transactions) than the Customer’s limit price on the complex order or individual leg(s). Also, if any leg of a complex order is nullified, the entire transaction is nullified.

3. Stock-Option Orders

Proposed Interpretation and Policy .07(c) governs stock-option orders. Proposed Rule 6.25.07(c) provides:

If the option leg of a stock-option order qualifies as an Obvious Error under paragraph (c)(1) or a Catastrophic Error under paragraph (d)(1), then the option leg that is an Obvious or Catastrophic Error will be adjusted in accordance with paragraph (c)(4)(A) or (d)(3), respectively, regardless of whether one of the parties is a Customer. However, the option leg of any Customer order subject to this paragraph (c) will be nullified if the adjustment would result in an execution price higher (for buy transactions) or lower (for sell transactions) than the Customer’s limit price on the stock-option order, and the Exchange will attempt

¹⁶ Rule 6.25(c)(4)(C) also requires the orders resulting in 200 or more Customer transactions to have been submitted during the course of 2 minutes or less.

to nullify the stock leg. Whenever a stock trading venue nullifies the stock leg of a stock-option order or whenever the stock leg cannot be executed, the Exchange will nullify the option leg upon request of one of the parties to the transaction or in accordance with paragraph (c)(3).

Similar to proposed Interpretation and Policy .07(a), an option leg (or legs) of a stock-option order must qualify as an obvious or catastrophic error under the initial harmonized rule in order for the stock-option order to qualify as an obvious or catastrophic error. Also, similar to proposed Rule 6.25.07(a), if an option leg (or legs) does qualify as an obvious or catastrophic error, the option leg (or legs) will be adjusted in accordance with paragraph (c)(4)(A) or (d)(3), respectively, regardless of whether one of the parties is a Customer. Again, as with proposed Rule 6.25.07(a), where at least one party to a complex order transaction is a Customer, the Exchange will nullify the option leg and attempt to nullify the stock leg if adjustment would result in an execution price higher (for buy transactions) or lower (for sell transactions) than the Customer's limit price on the complex order or individual leg(s).

Finally, the Exchange proposes to provide guidance that whenever the stock trading venue nullifies the stock leg of a stock-option order, the option will be nullified upon request of one of the parties to the transaction or by an Official acting on their own motion in accordance with paragraph (c)(3). The Exchange states that there are situations in which buyer and seller agree to trade a stock-option order, but the stock leg cannot be executed. Thus, the Exchange proposes to provide that whenever the stock portion of a stock-option order cannot be executed, the Exchange will nullify the option leg upon request of one of the parties to the transaction or on an Official's own motion.

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 April 17, 2017.¹⁷

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.¹⁸ In particular, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of Section 6(b) of the Act¹⁹ and with Section 6(b)(5) of the Act,²⁰ 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 6.25 will help assure greater objectivity, transparency, and clarity with respect to the adjustment and nullification of erroneous options transactions and, in particular, those involving complex order or stock-option order 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 protecting the public interest. In particular, the proposal is designed to increase the consistency and transparency in

¹⁷ See Amendment No. 1.

¹⁸ In approving this proposed rule change, as amended, 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).

¹⁹ 15 U.S.C. 78f(b).

²⁰ 15 U.S.C. 78f(b)(5).

the handling of erroneous options transactions among those options exchanges that allow complex order or stock-option order transactions.

In its order approving the initial harmonized rule of BATS Exchange, Inc., the Commission noted that the options exchanges intended to work together to further develop additional objectivity with respect to their processes for the adjustment and nullification of erroneous options transactions.²¹ The Commission believes that the proposed rule change to specifically delineate the treatment of erroneous complex order or stock-option order transactions constitutes an additional step towards this goal. Based on the foregoing, the Commission believes that the proposed rule change is consistent with Section 6(b)(5) of the Act²² in that proposed Rule 6.25 will foster cooperation and coordination with persons engaged in regulating and facilitating transactions.

The Commission notes that the proposed rule change will become operative on April 17, 2017. This delayed implementation is to ensure that other options exchanges that permit transactions in complex orders or stock-option orders will have sufficient time to put in place similar rules consistent with this proposed rule change and to coordinate the date of implementation of such harmonized rules.²³

²¹ See BATS Order, supra note 5, at 16039.

²² 15 U.S.C. 78f(b)(5).

²³ See Amendment No. 1.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁴ that the proposed rule change, as modified by Amendment No. 1 (SR-CBOE-2016-088) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁵

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²⁴ 15 U.S.C. 78s(b)(2).

²⁵ 17 CFR 200.30-3(a)(12).