

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-83205; File No. SR-CBOE-2018-008)

May 9, 2018

Self-Regulatory Organizations; Cboe Exchange, Inc.; Order Approving a Proposed Rule Change Relating to Flexibly Structured Options

I. Introduction

On January 18, 2018, 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 amending Cboe Options’s rules relating to the fungibility of Flexible Exchange Options (“FLEX Options”). The proposed rule change was published for comment in the Federal Register on February 8, 2018.³ On March 23, 2018, 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 the proposed rule change should be disapproved.⁴ The Commission received no comment letters on the proposed rule change. This order approves the proposed rule change.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 82622 (Feb. 2, 2018), 83 FR 5668 (Feb. 8, 2018) (“Notice”).

⁴ See Securities Exchange Act Release No. 82936 (Mar. 23, 2018), 83 FR 13552 (Mar. 29, 2018).

II. Description of the Proposed Rule Change

In its filing, the Exchange proposed to amend Interpretation and Policy .02 to Rule 24A.4, which sets forth requirements relating to a FLEX Option that has the same terms as a Non-FLEX Option.⁵

First, Cboe Options has proposed to amend the rule to make all FLEX Options fungible with Non-FLEX Options that have identical terms.⁶ Currently, FLEX Options that have quarterly expirations,⁷ short term expirations,⁸ weekly expirations,⁹ and End of Month (“EOM”) expirations¹⁰ are not fungible with Non-FLEX Options with identical terms.¹¹ The OCC currently prohibits fungibility in quarterly and short-term options,¹² so, as described in more detail below, Cboe Options proposes to delay the effectiveness of this proposed rule change to allow time for OCC to amend its bylaws.

⁵ See Cboe Options Rule 24A.1(q).

⁶ See proposed Cboe Options Rule 24A.4.02(a) (“[t]his Interpretation and Policy shall apply to all FLEX Options”).

⁷ See Cboe Options Rules 5.5(e), 24.9(a)(2)(B), and 24.9(c).

⁸ See Cboe Options Rules 5.5(d) and 24.9(a)(2)(A).

⁹ See Cboe Options Rule 24.9(e). These are currently traded pursuant to the Nonstandard Expirations Pilot Program.

¹⁰ Id. These are also traded pursuant to the Nonstandard Expiration Pilot Program.

¹¹ Cboe Options states in its proposal that FLEX Options with these expirations were not originally intended to be fungible. See Securities Exchange Release Act Nos. 62658 (August 5, 2010), 75 FR 49010, 49011 n.8 (August 12, 2010) (SR-CBOE-2009-075) (notice). The notice states that FLEX Options do not become fungible with subsequently introduced Non-FLEX structured quarterly and short term options, and that they will not be with End of Week (“EOW”) and EOM expirations because of their similarities to the quarterly and short term options. EOW expirations are now called weekly expirations as Cboe Options Rule 24.9(e) was amended to include Monday and Wednesday expirations. See also Securities Exchange Release Act No. 62911 (September 14, 2010), 75 FR 57539 (September 21, 2010) (SR-CBOE-2009-075) (approval order).

¹² See Article I of OCC By-Laws.

Second, the Exchange has proposed to clarify that if the expiration date is an Exchange holiday, Cboe Options Rule 24A.4.02 shall designate the previous business day as the expiration date.¹³ However, for weekly expirations that expire on a Monday that is an Exchange holiday,¹⁴ Cboe Options Rule 24A.4.02 shall designate the business day that immediately follows the Exchange holiday as the expiration date.¹⁵ According to the Exchange, the proposed rule is designed to clarify that when the expiration of a Non-FLEX Option is moved to the business day immediately before (or after) the Exchange holiday, the FLEX Option that also expires on the day before (or after) will be fungible with the Non-FLEX Option.¹⁶

Third, Cboe Options has proposed to clarify that in the event a Non-FLEX American-style series is added intra-day, a FLEX position is permitted to be closed using FLEX trading procedures for the balance of the trading day on which the Non-FLEX series is added against another closing only FLEX position.¹⁷ The Exchange notes that when it was adopted, the Exchange intended to limit this provision to American-style exercises. According to the Exchange, American-style options face assignment risk because when a Non-FLEX Option is listed, the OCC cannot net the positions of the Non-FLEX Option and the FLEX Option with identical terms until the next business day.¹⁸

¹³ See Proposed Cboe Options Rule 24A.4.02(a).

¹⁴ See Cboe Options Rule 24.9(e)(1).

¹⁵ See Proposed Cboe Options Rule 24A.4.02(a).

¹⁶ See Notice, supra note 3, at 5669.

¹⁷ See proposed Cboe Options Rule 24A.4.02(b).

¹⁸ See Notice, supra note 3, at 5669 n.7. See also Securities Exchange Act Release No. 62870 (September 8, 2010), 75 FR 56147 (September 15, 2010) (SR-CBOE-2010-078) (stating that there is assignment risk for American-style options only). The Commission notes that an American-style option may be exercised at any time during its life, whereas, a European-style option may only be exercised at the end of its life.

Fourth, the Exchange has proposed several non-substantive changes that are designed to make the text easier to read. The Exchange believes that such changes will clarify that the fungibility provisions apply to FLEX Options series with terms identical to the terms of a Non-FLEX Options series.¹⁹

Finally, the proposed rule text provides that the Exchange's current rule will remain in effect until the effective date specified by the Exchange in a Regulatory Circular.²⁰ The Regulatory Circular announcing the effective date shall be issued at least 30 days prior to the effective date²¹ and such effective date shall be no later than July 31, 2018.²² As noted in Cboe Options's proposal,²³ the delayed effectiveness is intended to allow OCC time to amend its bylaws to eliminate its current restriction on fungibility of certain options.

III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act²⁴ and the rules and regulations thereunder applicable to a national securities exchange.²⁵ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,²⁶ 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,

¹⁹ See Notice, supra note 3, at 5669.

²⁰ Id. at 5670.

²¹ Id.

²² Id.

²³ Id.

²⁴ 15 U.S.C. 78f.

²⁵ 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).

²⁶ 15 U.S.C. 78f(b)(5).

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.

The Commission notes that the rules concerning the fungibility of certain FLEX Options and Non-FLEX Options were previously approved by the Commission.²⁷ The proposed rule change extends fungibility to quarterly expirations, short term expirations, and, to the nonstandard expiration pilot program weekly and EOM expirations. The Commission believes that amending Rule 24A.4.02 to allow these additional FLEX Options to become fungible with standardized options with identical terms could result in some benefits to FLEX Options participants in that it may potentially increase the liquidity available to traders of FLEX Options. As the Exchange noted in its rule proposal, this is because there are more market participants in the Non-FLEX Options and thus there is potentially more liquidity available to market participants with FLEX Options that will be able to exit their FLEX Options positions in the standardized Non-FLEX Option market.²⁸

Because FLEX Options in quarterly, short term, weekly, and EOM expirations are not fungible with their Non-FLEX counterparts, parallel markets in these expirations exist - one FLEX and one Non-FLEX. The Commission previously stated that it is concerned that FLEX Options could act as a surrogate for trading in standardized options.²⁹ The Commission recognizes that the FLEX Options market is designed to combine the benefits of an auction market with the features of negotiated transactions, and therefore continuous quotes may not

²⁷ See Securities Exchange Act Release No. 59417 (Feb. 18, 2009), 74 FR 8591 (Feb. 25, 2009) (SR-CBOE-2009-115).

²⁸ See Notice, supra note 3, at 5670.

²⁹ See 74 FR at 8593.

always be available. Permitting more expirations in FLEX Options to be fungible with their Non-FLEX counterparts could help to ensure that market participants cannot avoid the protections provided to investors in the standardized market for these expirations by trading FLEX Options. Specifically, once a Non-FLEX series is open for trading, new FLEX Options are not permitted in that series. In addition, once a Non-FLEX Options series is open, all outstanding FLEX Options in the same series become fungible with Non-FLEX Options in the standardized market, are traded pursuant to standardized market trading rules, and are aggregated for position and exercise limit purposes. Allowing these FLEX Options to be fungible with their Non-FLEX counterparts could potentially address some of these surrogacy concerns.

Nevertheless, the FLEX market was originally intended to allow customization of option terms that were not available in the standardized options. While this has evolved over time with the current fungibility provisions, as the additional classes of options noted above are allowed to become fungible with identical term standardized options, some of which have much shorter terms to expiration, we expect the Exchange to carefully monitor the fungible FLEX Options (and standardized options counterparts) to ensure that they are not being used in a way to trade ahead and/or gain an advantage over other market participants prior to the standardized options becoming available to all market participants.

Furthermore, the Commission expects the Cboe Options to report any undue effects that may occur as a result of these fungibility rule changes, including taking prompt action should any unanticipated consequences occur. The Commission also expects, prior to the effective date of the new rule, the Exchange to address whether additional position limit aggregation rules should be adopted prior to the rule's delayed implementation date. We note that currently the

FLEX rules require that certain FLEX Options positions be aggregated with the position limits in the standardized market.³⁰

The Commission believes that the remaining proposed changes will help protect investors and the public interest by providing clarity and transparency to the rules. The proposed rule text regarding Exchange holidays will clarify the fungibility of FLEX Options with expiration dates on Exchange holidays and are consistent with the expiration of the same standardized options on Exchange holidays. Amending the intra-day add provision to state that it applies solely to American-style expirations will codify in the rule text the Exchange's original intent with respect to this provision. Further, the other non-substantive, clarifying changes will make the rule easier to read and understand.

Finally, as noted above the Exchange cannot actually implement this rule change immediately because OCC bylaws currently restrict fungibility of quarterly and short term options. The Commission believes that the delayed implementation date of July 31, 2018 should provide OCC with time to consider fungibility in quarterly and short-term options and determine whether to amend the OCC By-laws to accommodate the changes being adopted by the Exchange. The Exchange has also committed to announce the implementation of the change at least 30 days prior to the effective date pursuant to a Regulatory Circular, which should provide adequate advance notice to market participants. To the extent OCC is not able to implement a bylaw change at or prior to the July 31, 2018, we would expect the Exchange to amend its rules or extend the implementation date.

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

³⁰ See Cboe Options Rule 24A.7, concerning FLEX position limits and reporting requirements.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³¹ that the proposed rule change (SR-CBOE-2018-008) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³²

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Assistant Secretary

³¹ 15 U.S.C. 78s(b)(2).

³² 17 CFR 200.30-3(a)(12).