

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-91116; File No. SR-CBOE-2020-050)

February 11, 2021

Self-Regulatory Organizations; Cboe Exchange, Inc.; Order Approving a Proposed Rule Change, as Modified by Amendment Nos. 1 and 2, to Amend Rules 5.37 and 5.73 Related to the Solicitation of Market Makers for SPX Initiating Orders in the Automated Improvement Mechanism and FLEX Automated Improvement Mechanism

I. Introduction

On June 3, 2020, Cboe Exchange, Inc. (“Exchange” or “Cboe”) 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 permit orders for the accounts of market makers with an appointment in S&P 500® Index Options (“SPX”) to be solicited for the initiating order submitted for execution against an agency order into an Automated Improvement Mechanism (“AIM”) auction or a FLEX AIM auction. The proposed rule change was published for comment in the Federal Register on June 18, 2020.³ On July 2, 2020, the Exchange submitted Amendment No. 1 to the proposed rule change, which replaced and superseded the proposed rule change in its entirety.⁴ On July 22, 2020, the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 89062 (June 12, 2020), 85 FR 36907. Comments received on the proposed rule change are available on the Commission’s website at: <https://www.sec.gov/comments/sr-cboe-2020-050/srcboe2020050.htm>.

⁴ In Amendment No. 1, the Exchange: (1) limited the scope of its original proposal, which would have permitted orders for the accounts of market makers with an appointment in any class to be solicited for the initiating order in an AIM or FLEX AIM auction in that class, to only allow market makers with an appointment in SPX to be solicited for the initiating order in an AIM or FLEX AIM auction in SPX; and (2) provided additional data, justification, and support for its modified proposal. The full text of Amendment No. 1 is available on the Commission’s website at: <https://www.sec.gov/comments/sr-cboe-2020-050/srcboe2020050-7382058-218888.pdf>.

Exchange submitted Amendment No. 2 to the proposed rule change.⁵ On July 27, 2020, pursuant to Section 19(b)(2) of the Act,⁶ 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.⁷ On August 21, 2020, the Commission published notice of Amendment Nos. 1 and 2 and instituted proceedings under Section 19(b)(2)(B) of the Act⁸ to determine whether to approve or disapprove the proposed rule change, as modified by Amendment Nos. 1 and 2.⁹ On December 8, 2020, pursuant to Section 19(b)(2) of the Act,¹⁰ the Commission designated a longer period within which to approve or disapprove the proposed rule change, as modified by Amendment Nos. 1 and 2.¹¹ This order approves the proposed rule change, as modified by Amendment Nos. 1 and 2.

⁵ In Amendment No. 2, the Exchange: (1) provided additional data, justification, and support for its proposal; and (2) made technical corrections and clarifications to the description of the proposal. The full text of Amendment No. 2 is available on the Commission's website at: <https://www.sec.gov/comments/sr-cboe-2020-050/srcboe2020050-7464399-221161.pdf>.

⁶ 15 U.S.C. 78s(b)(2).

⁷ See Securities Exchange Act Release No. 89398, 85 FR 46197 (July 31, 2020). The Commission designated September 16, 2020 as the date by which the Commission shall approve or disapprove, or institute proceedings to determine whether to disapprove, the proposed rule change.

⁸ 15 U.S.C. 78s(b)(2)(B).

⁹ See Securities Exchange Act Release No. 89635, 85 FR 53051 (August 27, 2020).

¹⁰ 15 U.S.C. 78s(b)(2).

¹¹ See Securities Exchange Act Release No. 90593, 85 FR 80842 (December 14, 2020). The Commission designated February 13, 2021 as the date by which the Commission shall approve or disapprove the proposed rule change, as modified by Amendment Nos. 1 and 2.

II. Description of the Proposal, as Modified by Amendment Nos. 1 and 2

The Exchange proposes to permit orders for the accounts of market makers with an appointment in SPX to be solicited for the initiating order submitted for execution against an agency order in SPX options into a simple AIM auction pursuant to Rule 5.37 or a simple FLEX AIM auction pursuant to Rule 5.73.¹² Currently, the introductory paragraphs of Rules 5.37 and 5.73 prohibit orders for the accounts of market makers with an appointment in the applicable class to be solicited to execute against the agency order in a simple AIM or FLEX AIM auction, respectively. The Exchange states that no similar restriction applies to crossing transactions in open outcry trading, where a significant portion of SPX options trade.¹³ The Exchange represents that brokers seeking liquidity to execute against customer orders on the trading floor regularly solicit appointed SPX market makers for this liquidity, as they are generally the primary source of pricing and liquidity for those options.¹⁴

The Exchange states that, during a period of time in which it suspended open outcry trading to help prevent the spread of the novel coronavirus and began operating in an all-electronic configuration, it activated AIM for SPX options and adopted a temporary rule change to permit market makers to be solicited for electronic crossing transactions in its exclusively-listed index options (including SPX options) when the Exchange's trading floor was

¹² The initiating order is the order comprised of principal interest or a solicited order(s) submitted to trade against the order the submitting trading permit holder (the "Initiating TPH" or "Initiating FLEX Trader," as applicable) represents as agent (the agency order). The Exchange states that AIM is currently not activated for SPX options, although FLEX AIM is currently activated for FLEX SPX options. See Amendment No. 1, supra note 4, at 4 & n.2.

¹³ See Rules 5.86 and 5.87. See also Amendment No. 1, supra note 4, at 4.

¹⁴ See Amendment No. 1, supra note 4, at 4.

inoperable.¹⁵ According to the Exchange, while AIM was activated for SPX options, the Exchange observed price improvement benefits in AIM auctions for smaller, retail-sized SPX options.¹⁶ Although the Exchange has deactivated AIM for SPX options with the reopening of its trading floor, the Exchange further states that, if it determines to reactivate AIM for SPX options, it believes it is appropriate to permit orders for the account of an appointed SPX market maker to be submitted as the contra order, as the Exchange believes the liquidity provided by SPX market makers is necessary for brokers to initiate AIM auctions and create potential price improvement opportunities for those retail-sized orders.¹⁷ The Exchange also states that with additional market participants available for solicitation to represent the initiating order, the increased competition may encourage these participants to provide more aggressive prices to initiate an auction in SPX.¹⁸

The Exchange further states that, in multi-list classes, many market makers serve as both appointed market makers on the Exchange and as market makers on other options exchanges and, as a result, can use their away market maker accounts to be solicited as a contra order for AIM auctions.¹⁹ The Exchange provides data from April 2020 demonstrating that approximately 99.6% of the orders submitted into all AIM auctions had initiating orders comprised of orders for

¹⁵ See id. at 4-5. See also Rule 5.24(e)(1)(A); Securities Exchange Act Release No. 88886 (May 15, 2020), 85 FR 31008 (May 21, 2020) (SR-CBOE-2020-047).

¹⁶ See Securities Exchange Act Release No. 89058 (June 12, 2020), 85 FR 36918 (June 18, 2020) (SR-CBOE-2020-051).

¹⁷ See Amendment No. 1, supra note 4, at 5-6.

¹⁸ See Amendment No. 2, supra note 5, at 4.

¹⁹ See Amendment No. 1, supra note 4, at 7.

accounts of away market makers, making up approximately 86.2% of the volume executed through AIM auctions.²⁰

According to the Exchange, however, because SPX is an exclusively-listed class on the Exchange, a firm cannot serve as an SPX market maker at another options exchange.²¹ The Exchange represents that there are currently 28 trading permit holders with SPX appointments that would be available to participate in AIM auctions through both contra orders and auction responses.²² The Exchange provides data showing that during April and May 2020, when initiating orders could be comprised of orders for accounts of SPX market makers pursuant to a temporary rule, approximately 22% of initiating orders executed in SPX AIM auctions were comprised of orders for SPX market makers, representing approximately 45% of SPX volume executed in AIM auctions.²³ The Exchange's data further demonstrates that during April and May 2020, while approximately 76% of initiating orders executed in SPX AIM auctions were comprised of orders for accounts of away market makers, those orders represented only approximately 5% of the SPX volume executed through AIM auctions.²⁴ The Exchange's data also shows that during April and May 2020, SPX market makers executed approximately 31% of SPX volume executed through AIM auctions with auction responses.²⁵

The Exchange also states that SPX market makers frequently serve as contra parties to crossing transactions on the trading floor and the proposed rule change will further align AIM

²⁰ See id.

²¹ See id.

²² See Amendment No. 2, supra note 5, at 3.

²³ See Amendment No. 1, supra note 4, at 7.

²⁴ See id.

²⁵ See id.

auctions with SPX crossing executions that occur on the trading floor. According to the Exchange, for example, during February 2020, approximately 76% of SPX orders crossed on the trading floor (consisting of 2,944,161 contracts) included an order of an SPX market maker on one side of the transaction.²⁶

With respect to FLEX AIM, the Exchange states that, unlike in simple non-FLEX markets, FLEX market makers have no obligations to provide liquidity to FLEX classes and there is no book into which FLEX market makers may submit quotes to rest. According to the Exchange, therefore, appointed market makers in FLEX markets are on equal footing with all other market participants with respect to FLEX AIM auctions and permitting FLEX market makers to be solicited as the contra order in a FLEX AIM auction would provide all market participants with the opportunity to provide liquidity to execute against agency orders in FLEX AIM auctions in the same manner (i.e., through solicitation and responses).²⁷

The Exchange also proposes to amend Rules 5.37(c)(5) and 5.73(c)(5) to codify that any user or FLEX Trader, respectively, other than the Initiating TPH or FLEX Trader, respectively, may submit responses to AIM and FLEX AIM auctions. The Exchange also proposes to specify that the system will reject a response with the same EFID as the initiating order.²⁸ The Exchange represents that if the same user submits a response to an auction in which that same user had an order comprising the initiating order (even with a different EFID), the Exchange may take

²⁶ See id. at 8.

²⁷ See id. at 9.

²⁸ See Rule 1.1 (defining EFID as an “Executing Firm ID”). The Exchange states that, although the system is only able to reject responses with the same EFID as the initiating order, the rule prohibits all responses from the same user that represents the initiating order, even if orders for the same user have different EFIDs. See Amendment No. 1, supra note 4, at 10.

regulatory action against that user for a violation of the proposed rule.²⁹ Further, with respect to any potential misuse of non-public information by an SPX market maker regarding an upcoming SPX AIM auction, the Exchange represents that it has existing rules that prohibit a pattern or practice of submitting orders or quotes for the purpose of disrupting or manipulating AIM auctions and that require trading permit holders to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, non-public information.³⁰

III. Discussion and Commission Findings

The Commission finds that the proposed rule change, as modified by Amendment Nos. 1 and 2, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.³¹ In particular, the Commission finds that the proposed rule change, as modified by Amendment Nos. 1 and 2, is consistent with Section 6(b)(5) of the Act,³² which requires, among other things, that the rules of a national securities 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 also finds that the proposed rule change, as modified by Amendment Nos. 1 and 2, is consistent with Section 6(b)(8) of the Act,³³ which requires that the rules of a

²⁹ See Amendment No. 1, supra note 4, at 10.

³⁰ See Amendment No. 2, supra note 5, at 5. See also Rules 5.37.02 and 8.10.

³¹ 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).

³² 15 U.S.C. 78f(b)(5).

³³ 15 U.S.C. 78f(b)(8).

national securities exchange do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

As described above, the Exchange proposes to permit orders for the accounts of market makers with an appointment in SPX to be solicited for the initiating order submitted for execution against an agency order in SPX options into an AIM auctions. In support of its proposal, the Exchange states that brokers seeking liquidity to execute against customer orders on the trading floor regularly solicit appointed SPX market makers for this liquidity, as they are generally the primary source of pricing and liquidity for those options. Accordingly, the Exchange believes the liquidity provided by SPX market makers is necessary for brokers to initiate AIM auctions and would create potential price improvement opportunities for retail-sized orders in SPX. As summarized in more detail above, the Exchange collected data during the time open outcry trading was temporarily suspended and SPX options traded in AIM auctions while the trading floor was inoperable. The data demonstrates that significant price improvement opportunities for retail-sized orders occurred during this time.

Two commenters agreed with Cboe that the proposal would increase liquidity for AIM auctions and thereby would increase execution and price improvement opportunities for retail investors.³⁴ One such commenter argued that removing the market maker solicitation prohibition would eliminate an inequity against market makers that unduly curtails liquidity to customer

³⁴ See letters to Vanessa Countryman, Secretary, Commission, from Richard J. McDonald, Susquehanna International Group, LLP, dated July 8, 2020, at 2 (“SIG Letter”) and Ellen Greene, Managing Director, Equities & Options Market Structure, The Securities Industry and Financial Markets Association, dated July 9, 2020, at 3 (“SIFMA Letter”). The SIG Letter and SIFMA Letter commented on Cboe’s original proposal, which would have applied the proposed rule change to all classes, not just SPX.

orders.³⁵ Commenters also supported the proposal because it would better align the execution and price improvement opportunities in electronic crossing auctions with those available in open outcry trading, where no similar solicitation prohibition exists.³⁶

After careful consideration, the Commission believes that the proposal is reasonably designed to protect investors and the public interest. The data provided by the Exchange supports the Exchange's conclusion that the proposal could provide additional execution and price improvement opportunities for customer orders in SPX options submitted through the Exchange's AIM auctions. As described above, the Exchange provided data demonstrating market maker participation in SPX AIM auctions during April and May 2020, the temporary period when SPX market makers were permitted to be solicited as contra side to the agency order in AIM auctions.³⁷ The Commission believes that the Exchange's data shows that SPX market makers represented a significant amount of SPX AIM volume during this period, both as initiating orders and through auction responses. Accordingly, the Exchange's data supports a finding that permanently permitting initiating orders from SPX market makers is designed to increase the number of AIM auctions and consequently, provide a larger number of agency orders with the opportunity for price improvement. For example, an AIM agency order for less than 50 contracts is guaranteed price improvement of at least one minimum increment better than the then-current National Best Bid or National Best Offer.³⁸

The Commission further believes that the proposed rule change will not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the

³⁵ See SIG Letter, supra note 34, at 1.

³⁶ See SIFMA Letter, supra note 34, at 3; SIG Letter, supra note 34, at 2.

³⁷ See supra notes 23-25 and accompanying text.

Act. SPX market makers frequently serve as contra parties to crossing transactions on the trading floor. For example, during February 2020 (when the trading floor was open), approximately 76% of SPX orders crossed on the trading floor (consisting of 2,944,161 contracts) included an order of an SPX market maker on one side of the transaction.³⁹ Cboe states that this demonstrates the importance of appointed SPX market makers to the provision of liquidity in the SPX market with respect to crossing transactions, which liquidity would not be available to initiate electronic crossing transactions under the current AIM rule.⁴⁰ Thus, the proposed rule change will further align open outcry and electronic crossing auctions in SPX and provide execution and price improvement opportunities in both auctions by permitting all market participants, not just Cboe SPX market makers, to be solicited to participate in AIM transactions.

Moreover, because the Exchange's rules no longer restrict the group of participants that may provide responses to AIM auctions,⁴¹ there are a number of appointed SPX market makers on the Exchange that would remain eligible to provide competitive responses to AIM auctions.⁴² According to the Exchange, there are currently 28 trading permit holders with SPX appointments that would be available to participate in AIM auctions through both contra orders and auction responses.⁴³ Further, the proposal would allow for an increased number of participants to provide the contra-side interest necessary to initiate a competitive AIM auction, particularly in an exclusively-listed class such as SPX where away market makers are unavailable to provide such

³⁹ See Amendment No. 1, supra note 4, at 8.

⁴⁰ See id.

⁴¹ See Rules 5.37(c)(5) (AIM) and 5.38(c)(5).

⁴² See text accompanying supra note 22.

⁴³ See Amendment No. 2, supra note 5, at 3.

interest. The Exchange's data demonstrated that during the temporary period, SPX market makers executed approximately 31% of SPX volume executed through AIM auctions with auction responses.⁴⁴

Accordingly, the Commission finds that the proposed rule change, as modified by Amendment Nos. 1 and 2, is consistent with the requirements of the Act.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁴⁵ that the proposed rule change, as modified by Amendment Nos. 1 and 2 (SR-CBOE-2020-050), be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁴⁶

J. Matthew DeLesDernier
Assistant Secretary

⁴⁴ See Amendment No. 1, supra note 4, at 7.

⁴⁵ 15 U.S.C. 78s(b)(2).

⁴⁶ 17 CFR 200.30-3(a)(12).