

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-91257; File No. SR-CBOE-2020-106)

March 4, 2021

Self-Regulatory Organizations; Cboe Exchange, Inc.; Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, as Modified by Amendment No. 1, to Amend its Rules Regarding the Minimum Increments for Electronic Bids and Offers and Exercise Prices of Certain FLEX Options and Clarify in the Rules How the System Ranks FLEX Option Bids and Offers for Allocation Purposes

On November 16, 2020, Cboe Exchange, Inc. filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend its rules regarding the minimum increments for electronic bids and offers and exercise prices of certain FLEX options and clarify how the system ranks FLEX option bids and offers for allocation purposes. On November 30, 2020, the Exchange filed Amendment No. 1 to the proposed rule change, which amended and replaced the proposed rule change in its entirety. The Commission published notice of the proposed rule change, as modified by Amendment No. 1, in the Federal Register on December 4, 2020.<sup>3</sup> On January 14, 2021, pursuant to Section 19(b)(2) of the Exchange Act,<sup>4</sup> 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.<sup>5</sup> The Commission has received no comments on

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 90536 (November 30, 2020), 85 FR 78381.

<sup>4</sup> 15 U.S.C. 78s(b)(2).

<sup>5</sup> See Securities Exchange Act Release No. 90926, 86 FR 6710 (January 22, 2021). The Commission designated March 4, 2021, as the date by which the Commission shall approve or disapprove, or institute proceedings to determine whether to disapprove, the proposed rule change.

the proposal. This order institutes proceedings under Section 19(b)(2)(B) of the Exchange Act<sup>6</sup> to determine whether to approve or disapprove the proposed rule change.

I. Description of the Proposal

The Exchange has proposed to amend the minimum increments for bids and offers and exercise prices of flexible exchange options (“FLEX Options”)<sup>7</sup> submitted to an electronic FLEX auction and make related changes to its rules.

The Exchange is proposing to change the permissible minimum increment for exercise price. The Exchange’s rules provide that, when submitting a FLEX Order,<sup>8</sup> the submitting FLEX trader must include all the required terms of a FLEX Options series, including an exercise (or strike) price.<sup>9</sup> According to the Exchange, the exercise price of a FLEX Option may currently be expressed as either (1) a fixed price expressed in terms of dollars and decimals or a specific index value, as applicable (which may not be smaller than \$0.01), or (2) a percentage of the closing value of the underlying equity security or index, as applicable, on the trade date (which may not be smaller than 0.01%).<sup>10</sup> The Exchange is proposing to amend CBOE Rule 4.21(b)(6)(A) to provide that, for FLEX Orders submitted to an electronic FLEX auction: (1) an exercise price expressed as a fixed

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<sup>6</sup> 15 U.S.C. 78s(b)(2)(B).

<sup>7</sup> See CBOE Rule 1.1.

<sup>8</sup> A “FLEX Order” is an order submitted in a FLEX Option. See CBOE Rule 5.70.

<sup>9</sup> See CBOE Rule 4.21(b) for a description of the terms of a FLEX Option series that a submitting FLEX trader must include in a FLEX Order.

<sup>10</sup> See CBOE Rule 4.21(b)(6). The Exchange states that, while the specific minimums for the exercise price are not currently included in CBOE Rule 4.21(b)(6), that rule indicates that the Exchange’s system rounds the exercise price to the nearest minimum increment as set forth in CBOE Rule 5.4, and the Exchange has interpreted the rule to mean that the minimum increment for the exercise price of FLEX Options is the same as the minimum increment for bids and offers of FLEX Options. The term “trade date” as used herein refers to the date on which the FLEX Option was bought or sold (i.e., the date on which the FLEX Option trade occurs).

price may be in increments no smaller than \$0.001; and (2) an exercise price expressed as a percentage of the closing value of the underlying equity security or index, as applicable, on the trade date may be in increments no smaller than 0.0001%.<sup>11</sup>

The Exchange also proposes to amend CBOE Rule 4.21(b)(6) to state that the Exchange may determine the smallest increment for exercise prices of FLEX Options on a class-by-class basis. The Exchange states that this codifies its longstanding interpretation of the current rule, which references the minimum increment for bids and offers as set forth in CBOE Rule 5.4. CBOE Rule 5.4(c)(4) provides that the Exchange may determine the minimum increment for bids and offers on FLEX Options on a class-by-class basis, which may be no smaller than the amounts specified in that rule. The Exchange states that it has therefore interpreted CBOE Rule 4.21(b)(6) to mean that those same provisions apply to the minimum increments for exercise prices for FLEX Options. The proposed rule change also adds to CBOE Rule 4.21(b)(6)(A)(ii) that the Exchange's system rounds the actual exercise price to the nearest fixed price minimum increment for bids and offers in the class (as set forth in CBOE Rule 5.4).

The Exchange is also proposing to amend the permissible minimum increment for bids and offers. The Exchange proposes to amend CBOE Rule 5.4(c)(4)(B), which currently provides that the minimum increment for bids and offers on FLEX Options with (1) an exercise price expressed as a fixed price may not be smaller than \$0.01 and (2) an exercise price expressed as a percentage of

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<sup>11</sup> The Exchange states that the proposed rule change will have no impact on the smallest increment for exercise prices for open outcry FLEX Orders and auction responses, which may be no smaller than \$0.01 (if the exercise price for the FLEX Option series is a fixed price) or 0.01% (if the exercise price for the FLEX Option series is a percentage of the closing value of the underlying equity security or index on the trade date). The proposed rule change adds language to clarify that these minimum increments for bids and offers will continue to apply to FLEX Orders and auction responses submitted to an open outcry auction. See proposed CBOE Rule 4.21(b)(6)(A).

the closing value of the underlying equity security or index on the trade date may not be smaller than 0.01%.<sup>12</sup> As proposed, CBOE Rule 5.4(c)(4) would provide that the minimum increment for bids and offers, for FLEX Orders and auction responses submitted to an electronic FLEX auction, with (1) an exercise price expressed as a fixed price may not be smaller than \$0.001; and (2) an exercise price expressed as a percentage of the closing value of the underlying equity security or index on the trade date may not be smaller than 0.0001%.<sup>13</sup>

In addition, the Exchange proposes to amend CBOE Rule 5.3(e)(3), which currently states that bids and offers for FLEX Options must be expressed in (a) U.S. dollars and decimals, if the exercise price for the FLEX Option series is a fixed price, or (b) a percentage, if the exercise price for the FLEX Option series is a percentage of the closing value of the underlying equity security or index on the trade date, per unit of the underlying security or index, as applicable. The Exchange's system rounds bids and offers to the nearest minimum increment. The proposed rule change states that bids and offers would be in the applicable minimum increment as set forth in CBOE Rule 5.4. As proposed, CBOE Rule 5.3(e)(3) would also state that the system rounds the final transaction prices to the nearest minimum fixed price increment for the class as set forth in CBOE Rule 5.4(c)(4)(A).

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<sup>12</sup> The Exchange determines the minimum increment for bids and offers on FLEX Options on a class-by-class basis. See CBOE Rule 5.4(c)(4).

<sup>13</sup> The Exchange states that the proposed rule change will have no impact on the minimum increment for bids and offers for open outcry FLEX Orders and auction responses, which minimum increment for bids and offers will continue to be \$0.01 (if the exercise price for the FLEX Option series is a fixed price) or 0.01% (if the exercise price for the FLEX Option series is a percentage of the closing value of the underlying equity security or index on the trade date). The proposed rule change adds language to clarify that these minimum increments for bids and offers will continue to apply to FLEX Orders and auction responses submitted to an open outcry auction. See proposed CBOE Rule 5.4(c)(4)(B).

The Exchange also proposes to amend CBOE Rules 5.72(c)(3)(A) and (d)(2), 5.73(e), and 5.74(e) to state how FLEX auction response bids and offers (as well as Initiating Orders and Solicitation Orders with respect to FLEX AIM Auctions and FLEX SAM Auctions, respectively) are ranked during the allocation process following each type of FLEX auction (i.e., electronic FLEX Auction, open outcry FLEX Auction, FLEX AIM Auction, and FLEX SAM Auction, respectively). The Exchange proposes to state that, for purposes of ranking responses, when determining how to allocate an order and responses, the term “price” refers to (1) the dollar and decimal amount of the order or response bid or offer or (2) the percentage value of the order or response bid or offer, as applicable. According to the Exchange, FLEX Orders will always first be allocated to responses at the best price, as applicable.<sup>14</sup> With respect to responses to all types of FLEX auctions for a FLEX Option series with an exercise price expressed as a dollar and decimal, the “prices” at which FLEX traders submitting responses are competing are the dollar and decimal amounts of the response bids and offers entered as fixed amounts (as is the case with all non-FLEX options), and the Exchange states that the proposed rule change codifies this in the Exchange’s rules. With respect to responses to all types of FLEX auctions for a FLEX Option series with an exercise price expressed as a percentage, the “prices” at which FLEX traders submitting responses are competing are the percentage values of the response bids and offers entered as percentages (which ultimately become a dollar value after the closing value for the underlying security or index, as applicable, is available), and according to the Exchange, the proposed rule change codifies this in its rules.

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<sup>14</sup> The Exchange states that the proposed rule change also clarifies this in CBOE Rule 5.72(d)(2) by adding a cross-reference to CBOE Rule 5.85(a)(1), which states that, with respect to open outcry trading on the Exchange’s trading floor, bids and offers with the highest bid and lowest offer have priority. The Exchange states that this is a nonsubstantive change that is currently true for open outcry FLEX auctions, and the proposed rule change merely makes this explicit in CBOE Rule 5.72(d)(2), which cross-reference was previously inadvertently omitted from the Exchange’s rules.

II. Proceedings to Determine Whether to Approve or Disapprove SR-CBOE-2020-106 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Exchange Act<sup>15</sup> to determine whether the proposed rule change should be approved or disapproved. Institution of such proceedings is appropriate at this time in view of the legal and policy issues raised by the proposed rule change, as discussed below. Institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, as stated below, the Commission seeks and encourages interested persons to provide comments on the proposed rule change to inform the Commission's analysis of whether to approve or disapprove the proposal.

Pursuant to Section 19(b)(2)(B) of the Exchange Act,<sup>16</sup> the Commission is providing notice of the grounds for disapproval under consideration. The Commission is instituting proceedings to allow for additional analysis of the proposed rule change's consistency with the Exchange Act, and, in particular, with Section 6(b)(5) of the Exchange Act, 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.<sup>17</sup>

FLEX Options allow market participants certain flexibility in setting specific terms of a FLEX Options contract consistent with Exchange rules.<sup>18</sup> The proposal would permit traders to

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<sup>15</sup> 15 U.S.C. 78s(b)(2)(B).

<sup>16</sup> Id.

<sup>17</sup> 15 U.S.C. 78f(b)(5).

<sup>18</sup> See CBOE Rules 4.20-4.22.

establish exercise prices for FLEX Options that are in smaller increments than those available on the non-FLEX options market.<sup>19</sup> As a result, the proposal would permit trading of FLEX and non-FLEX options that are in all terms the same, but for a differentiation of \$0.001 or 0.0001% of the exercise price. Therefore, under the proposal, FLEX Options, with no meaningful economic difference from non-FLEX options that overly the same underlying security or index, could avoid the priority and price protections provided to customer orders that exist in the non-FLEX options market by permitting such FLEX Option orders to trade ahead of customers on the Exchange's order book and/or trade through the national best bid or offer ("NBBO") in the non-FLEX options market. Accordingly, the proposal could allow FLEX Options, with decimal exercise price differences that, for all practical purposes, are insignificant as compared to the exercise price of a non-FLEX option, to gain priority over economically equivalent non-FLEX option customer orders on the book and/or trade through the NBBO. As a result, there are questions as to whether the proposal is consistent with Section 6(b)(5) of the Exchange Act and the requirements that the rules of the exchange be designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, and in general, to protect investors and the public interest.

While the Exchange states that there is demand from customers for the additional precision the proposal would allow and that the proposal would encourage trading of customized options that is currently available on the OTC market, the Exchange does not address the impact on customers and market quality in the Exchange's non-FLEX options market. Accordingly, the proposal raises questions as to whether any potential benefit of order flow migrating from the OTC market to the Exchange would outweigh the potential costs of orders moving from the non-

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<sup>19</sup> See, e.g., Interpretations and Policies to CBOE Rule 4.5.

FLEX options market to the less transparent FLEX Options market and the impact on market quality and customer orders in the non-FLEX options market.

The proposal would also permit FLEX traders to submit bids and offers, and therefore trade at prices, that are in smaller increments than those available on the non-FLEX options market. The Exchange asserts that, because the electronic auction responses are generally not visible to other FLEX traders, and there is no displayed liquidity to step ahead of, traders will be unable to purposefully increase bids and offers by trivial amounts and step ahead of other traders' prices. The Exchange also states that auction prices are not intended to serve as a price-setting function. The Exchange states it believes that, as a result of these factors, sub-increment bids and offers for electronic FLEX auctions will not diminish liquidity in FLEX auctions. Auction prices for FLEX SAM Auctions, however, are disseminated. With respect to FLEX SAM Auctions, the proposal could increase the risk that traders can step ahead of other traders by amounts that are economically insignificant. In its proposal, the Exchange did not address this risk and the potential impact of the proposal on FLEX SAM Auctions and its consistency with Section 6(b)(5) of the Exchange Act including, among others, investor protection.

Moreover, the Exchange does not explain how it will ensure that, under the proposed decimal pricing, bids and offers are being improved at increments that are meaningful to market participants.<sup>20</sup> There is potential that the increased complexity created by the proposed pricing increments could have the effect of reducing participation in FLEX auctions and thereby lead to less competitive prices. The Exchange itself has acknowledged in a different context in another proposal that de minimis price improvement may discourage market participants from providing

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<sup>20</sup> For example, it is possible traders could use open outcry on the trading floor to obtain a quote, and then use this information to enter an economically equivalent option in a FLEX auction at a de minimis price difference.

contra-side interest at the best prices and liquidity providers from joining or improving at meaningful increments.<sup>21</sup> In its proposal, the Exchange did not address if the increased pricing options could similarly have the potential to make it harder for market participants to anticipate auction prices, which could affect market quality and decrease FLEX Options market participation.<sup>22</sup>

Finally, the Exchange states that it is codifying its policy to rank exercise prices based on percentages prior to converting them to dollar amounts once the closing price is available. The Exchange states it has always ranked percentage orders this way. The Exchange does not discuss, however, that if the order had been ranked at the close, some percentage responses would be rounded to the same price as other percentage responses, and therefore, be able to participate in the order. The Exchange does not address that, in the example it provided in its filing, a percentage sell response of 7.02% would currently round to the same two decimals as the sell response of 7.01%, but given the ranking at the end of the auction before rounding, only the 7.01% response would receive the execution. While there may be a reasonable rationale for ranking prior to rounding, the Exchange should address why it believes ranking as proposed is consistent with the Exchange Act.

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<sup>21</sup> See Securities Exchange Act Release No. 89638 (August 21, 2020), 85 FR 53045 (August 21, 2020) (SR-CBOE-2020-052) at 36925 stating, among other things, that “...the Exchange believes that the current manner in which de minimis price improvement may occur via C-AIM, as well as FLEX C-AIM, Auctions in connection with Index Combo Orders in SPX (i.e., potentially only improved in sub-penny increments) may discourage market participants from providing contra-side interest at the best prices and liquidity providers from joining or improving at meaningful increments.”

<sup>22</sup> *Id.* at 30348 stating, among other things, that “The Exchange believes that lack of an indication of where an auction is set to begin, like the ballpark figure provided by the trading crowd when crossing on the trading floor, may cause apprehension in pricing competitive responses during the electronic auctions in SPX, which may reduce liquidity and price improvement during such auctions.”

The Commission notes that, under the Commission’s Rules of Practice, the “burden to demonstrate that a proposed rule change is consistent with the Exchange Act and the rules and regulations thereunder...is on the self-regulatory organization [“SRO”] that proposed the rule change.”<sup>23</sup> The description of a proposed rule change, its purpose and operation, its effect, and a legal analysis of its consistency with applicable requirements must all be sufficiently detailed and specific to support an affirmative Commission finding,<sup>24</sup> and any failure of an SRO to provide this information may result in the Commission not having sufficient basis to make an affirmative finding that a proposed rule change is consistent with the Exchange Act and the applicable rule and regulations.<sup>25</sup>

For these reasons, the Commission believes it is appropriate to institute proceedings pursuant to Section 19(b)(2)(B) of the Exchange Act<sup>26</sup> to determine whether the proposal should be approved or disapproved.

### III. Procedure: Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the issues identified above, as well as any other concerns they may have with the proposal. In particular, the Commission invites the written views of interested persons concerning whether the proposal is consistent with Section 6(b)(5) or any other provision of the Exchange Act, or the rules and regulations thereunder. Although there do not appear to be any issues relevant to approval or disapproval that would be facilitated by an

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<sup>23</sup> Rule 700(b)(3), Commission Rules of Practice, 17 CFR 201.700(b)(3).

<sup>24</sup> See id.

<sup>25</sup> See id.

<sup>26</sup> 15 U.S.C. 78s(b)(2)(B).

oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4, any request for an opportunity to make an oral presentation.<sup>27</sup>

Interested persons are invited to submit written data, views, and arguments regarding whether the proposal should be approved or disapproved by [insert date 21 days from publication in the Federal Register]. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by [insert date 35 days from publication in the Federal Register].

The Commission asks that commenters address the sufficiency of the Exchange's statements in support of the proposal, which are set forth in the Notice,<sup>28</sup> in addition to any other comments they may wish to submit about the proposed rule change.

Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2020-106 on the subject line.

Paper comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

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<sup>27</sup> Section 19(b)(2) of the Exchange Act, as amended by the Securities Act Amendments of 1975, Pub. L. 94-29 (June 4, 1975), grants the Commission flexibility to determine what type of proceeding – either oral or notice and opportunity for written comments – is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Act Amendments of 1975, Senate Comm. on Banking, Housing & Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 30 (1975).

<sup>28</sup> See supra note 3.

All submissions should refer to File Number SR-CBOE-2020-106. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All

submissions should refer to File Number SR-CBOE-2020-106 and should be submitted on or before [insert date 21 days from publication in the Federal Register]. Rebuttal comments should be submitted by [insert date 35 days from date of publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>29</sup>

J. Matthew DeLesDernier  
Assistant Secretary

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<sup>29</sup> 17 CFR 200.30-3(a)(57).