

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-69342; File No. SR-MIAX-2013-12)

April 8, 2013

Self-Regulatory Organizations; Miami International Securities Exchange LLC; Order Granting Accelerated Approval of a Proposed Rule Change Relating to Obvious Errors in Limit or Straddle States

I. Introduction

On March 22, 2013, Miami International Securities Exchange LLC (“MIAX” or “Exchange”) 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 provide for how the Exchange proposes to treat erroneous options transactions in response to the Regulation NMS Plan to Address Extraordinary Market Volatility (the “Plan”). The proposed rule change was published for comment in the Federal Register on March 27, 2013.³ The Commission received one comment letter on the proposal.⁴ This order approves the proposed rule change on an accelerated basis.

II. Description of the Proposed Rule Change

Since May 6, 2010, when the financial markets experienced a severe disruption, the equities exchanges and the Financial Industry Regulatory Authority have developed market-wide measures to help prevent a recurrence. In particular, on May 31, 2012, the Commission approved the Plan, as amended, on a one-year pilot basis.⁵ The Plan is designed to prevent trades

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 69210 (March 22, 2013), 78 FR 18637 (“Notice”).

⁴ See Letter to Elizabeth M. Murphy, Secretary, Commission, from Douglas M. Schafer, Executive Vice President, Chief Information Officer, MIAX, dated February [sic] 5, 2013 (“MIAX Letter”).

⁵ Securities Exchange Act Release No. 67091 (May 31, 2012), 77 FR 33498.

in individual NMS stocks from occurring outside of specified Price Bands, creating a market-wide limit up-limit down mechanism that is intended to address extraordinary market volatility in NMS Stocks.⁶

In connection with the implementation of the Plan, the Exchange proposes to adopt Commentary .06 to Rule 521 to exclude trades that occur during a Limit State or Straddle State from the obvious error or catastrophic error review procedures pursuant to Rule 521 for a one year pilot basis following the adoption of the proposed rule change.⁷ The Exchange proposes to adopt new Rule 530(j) to apply to erroneous transactions in options when the underlying NMS Stock has entered either a Limit or Straddle State. In addition, the Exchange proposes to retain the ability to review all erroneous transactions that occur during Limit States and Straddle States resulting only from a verifiable disruption or malfunction of an Exchange execution, dissemination or communication system pursuant to new Rule 530(j).

Rule 521 provides a process by which a transaction may be nullified or adjusted when the execution price of a transaction deviates from the option's theoretical price by a certain amount. Generally, the theoretical price of an option is the National Best Bid and Offer ("NBBO") of the option. In certain circumstances, Exchange officials have the discretion to determine the theoretical price.⁸

⁶ Unless otherwise specified, capitalized terms used in this rule filing are based on the defined terms of the Plan.

⁷ The Exchange stated that members of the Exchange staff have spoken to its member organizations about obvious and catastrophic errors during a Limit State or Straddle State and that the Exchange has received generally favorable feedback concerning its proposed rule change, given the built-in customer protections in the Exchange system.

⁸ Specifically, under Rule 521, the theoretical price is determined in one of three ways: (i) if the series is traded on at least one other options exchange the last National Best Bid price with respect to an erroneous sell transaction and the last National Best Offer price with respect to an erroneous buy transaction, just prior to the trade; (ii) as determined by an Exchange Official, if there are no quotes for comparison purposes, or if the bid/ask

The Exchange believes that none of these methods is appropriate during a Limit State or Straddle State. Under Rule 521(b)(1), the theoretical price is determined with respect to the NBBO for an option series just prior to the trade. According to the Exchange, during a Limit State or Straddle State, options prices may deviate substantially from those available prior to or following the state. The Exchange believes this provision would give rise to much uncertainty for market participants as there is no bright line definition of what the theoretical price should be for an option when the underlying NMS stock has an unexecutable bid or offer or both. Because the approach under Rule 521(b)(1) by definition depends on a reliable NBBO, the Exchange does not believe that approach is appropriate during a Limit State or Straddle State.

Additionally, because the Exchange system will only trade through the theoretical bid or offer if the Exchange or the participant (via an ISO order) has accessed all better priced interest away in accordance with the Options Order Protection and Locked/Crossed Markets Plan, the Exchange believes potential trade reviews of executions that occurred at the participant's limit price and also in compliance with the aforementioned Plan could harm liquidity and also create an advantage to either side of an execution depending on the future movement of the underlying stock.

With respect to Rule 521(b)(2), affording discretion to the Exchange Official to determine the theoretical price and thereby, ultimately, whether a trade is busted or adjusted and to what price, the Exchange notes that it would be difficult to exercise such discretion in periods of extraordinary market volatility and, in particular, when the price of the underlying security is

differential of the NBBO for the affected series, just prior to the erroneous transaction, was at least two times the standard bid/ask differential as permitted for pre-opening quotes under Rule 603(b)(4); or (iii) for transactions occurring as part of the Exchange's automated opening system, the Theoretical Price shall be the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s).

unreliable. The Exchange again notes that the theoretical price in this context would be subjective.⁹ Ultimately, the Exchange believes that adding certainty to the execution of orders in these situations should encourage market participants to continue to provide liquidity to the Exchange, thus promoting fair and orderly markets. On balance, the Exchange believes that removing the potential inequity of nullifying or adjusting executions occurring during Limit States or Straddle States outweighs any potential benefits from applying these provisions during such unusual market conditions.

In response to these concerns, the Exchange proposes to adopt Commentary .06 to Rule 521, which provides that transactions in MIAX options that overly an NMS stock are not subject to obvious error or catastrophic error review under Rule 521 during a Limit State or Straddle State. In addition, the Exchange proposes to adopt new Rule 530(j) to allow the Exchange to review all erroneous transactions occurring during Limit States and Straddle States that resulted only from a verifiable disruption or malfunction of an Exchange execution, dissemination or communication system. Accordingly, the Exchange is proposing to incorporate the relevant portions of Rule 521 into proposed Rule 530(j) to establish the process for such review. Proposed Rule 530(j) also will include analogous language to that used in current Rule 521 regarding mutual agreement by the parties to an erroneous transaction during a trading halt (i.e., trades on the Exchange will be nullified when (i) the trade occurred during a trading halt in the affected option on the Exchange, or (ii) respecting equity options, the trade occurred during a trading halt on the primary market for the underlying security) and the relevant elements of Rule

⁹ The Exchange also notes that the determination of theoretical price under Rule 521(b)(3) applies to trades executed during openings. Because the Exchange does not intend to open an option during a Limit State or Straddle State, this provision will not apply.

521 regarding the review procedure, requests for review and appeals from decisions to bust a trade.

III. Discussion

The Commission finds that the Exchange's proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.¹⁰ Specifically, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,¹¹ in that it is designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, protect investors and the public interest.

In the filing, the Exchange notes its belief that suspending certain aspects of Rule 521 during a Limit State or Straddle State will ensure that limit orders that are filled during a Limit or Straddle State will have certainty of execution in a manner that promotes just and equitable principles of trade and removes impediments to, and perfects the mechanism of, a free and open market and a national market system. The Exchange believes the application of the current rule would be impracticable given what it perceives will be the lack of a reliable NBBO in the options market during Limit States and Straddle States, and that the resulting actions (*i.e.*, nullified trades or adjusted prices) may not be appropriate given market conditions. In addition, given the Exchange's view that options prices during Limit States or Straddle States may deviate

¹⁰ 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).

¹¹ 15 U.S.C. 78f(b)(5).

substantially from those available shortly following the Limit State or Straddle State, the Exchange believes that providing market participants time to re-evaluate a transaction executed during a Limit or Straddle State will create an unreasonable adverse selection opportunity that will discourage participants from providing liquidity during Limit States or Straddle States. Ultimately, the Exchange believes that adding certainty to the execution of orders in these situations should encourage market participants to continue to provide liquidity to the Exchange during Limit States and Straddle States, thus promoting fair and orderly markets.

The Exchange, however, has proposed this rule change based on its expectations about the quality of the options market during Limit States and Straddle States. The Exchange states, for example, that it believes that application of the obvious and catastrophic error rules would be impracticable given the potential for lack of a reliable NBBO in the options market during Limit States and Straddle States. Given the Exchange's recognition of the potential for unreliable NBBOs in the options markets during Limit States and Straddle States, the Commission is concerned about the extent to which investors may rely to their detriment on the quality of quotations and price discovery in the options markets during these periods. This concern is heightened by the Exchange's proposal to exclude electronic trades that occur during a Limit State or Straddle State from the obvious error or catastrophic error review procedures pursuant to Rule 521. The Commission urges investors and market professionals to exercise caution when considering trading options under these circumstances. Broker-dealers also should be mindful of their obligations to customers that may or may not be aware of specific options market conditions or the underlying stock market conditions when placing their orders.

While the Commission remains concerned about the quality of the options market during the Limit and Straddle States, and the potential impact on investors of executing in this market

without the protections of the obvious or catastrophic error rules that are being suspended during the Limit and Straddle States, it believes that certain aspects of the proposal could help mitigate those concerns.

First, despite the removal of obvious and catastrophic error protection during Limit States and Straddle States, the Exchange states that there are additional measures in place designed to protect investors. For example, the Exchange states that by rejecting market orders, and cancelling pending market orders, only those orders with a limit price will be executed during a Limit State or Straddle State. Additionally, the Exchange notes the existence of SEC Rule 15c3-5 requiring broker-dealers to have controls and procedures in place that are reasonably designed to prevent the entry of erroneous orders. The Exchange will also continue to review erroneous transactions occurring during Limit or Straddle States that resulted from a verifiable disruption or malfunction of an Exchange execution, dissemination or communication system under proposed Rule 530(j). Finally, the Exchange states that the MIAX System is designed with built-in protection mechanisms to prevent trade through the NBBO price at the time of receipt of an order by more than one Minimum Price Variation. Therefore, on balance, the Exchange believes that removing the potential inequity of nullifying or adjusting executions occurring during Limit States or Straddle States outweighs any potential benefits from applying certain provisions during such unusual market conditions.

Finally, the Exchange has proposed that the changes be implemented on a one year pilot basis. The Commission believes that it is important to implement the proposal as a pilot. The one year pilot period will allow the Exchange time to assess the impact of the Plan on the options marketplace and allow the Commission to further evaluate the effect of the proposal prior to any proposal or determination to make the changes permanent. To this end, the Exchange has

committed to: (1) evaluate the options market quality during Limit States and Straddle States; (2) assess the character of incoming order flow and transactions during Limit States and Straddle States; and (3) review any complaints from members and their customers concerning executions during Limit States and Straddle States. Additionally, the Exchange has agreed to provide the Commission with data requested to evaluate the impact of the elimination of the obvious error rule, including data relevant to assessing the various analyses noted above. On April 5, 2013, the Exchange submitted a letter stating that it would provide specific data to the Commission and the public and certain analysis to the Commission to evaluate the impact of Limit States and Straddle States on liquidity and market quality in the options markets.¹² This will allow the Commission,

¹² In particular, the Exchange represented that, at least two months prior to the end of the one year pilot period of proposed Rule 6.65A(c), it would provide to the Commission an evaluation of (i) the statistical and economic impact of Straddle States on liquidity and market quality in the options market and (ii) whether the lack of obvious error rules in effect during the Limit States and Straddle States are problematic. In addition, the Exchange represented that each month following the adoption of the proposed rule change it would provide to the Commission and the public a dataset containing certain data elements for each Limit State and Straddle State in optionable stocks. The Exchange stated that the options included in the dataset will be those that meet the following conditions: (i) the options are more than 20% in the money (strike price remains greater than 80% of the last stock trade price for calls and strike price remains greater than 120% of the last stock trade price for puts when the Limit State or Straddle State is reached); (ii) the option has at least two trades during the Limit State or Straddle State; and (iii) the top ten options (as ranked by overall contract volume on that day) meeting the conditions listed above. For each of those options affected, each dataset will include, among other information: stock symbol, option symbol, time at the start of the Limit State or Straddle State and an indicator for whether it is a Limit State or Straddle State. For activity on the Exchange in the relevant options, the Exchange has agreed to provide executed volume, time-weighted quoted bid-ask spread, time-weighted average quoted depth at the bid, time-weighted average quoted depth at the offer, high execution price, low execution price, number of trades for which a request for review for error was received during Limit States and Straddle States, an indicator variable for whether those options outlined above have a price change exceeding 30% during the underlying stock's Limit State or Straddle State compared to the last available option price as reported by OPRA before the start of the Limit or Straddle state (1 if observe 30% and 0 otherwise), and another indicator variable for whether the option price within five minutes of the underlying stock leaving

the Exchange, and other interested parties to evaluate the quality of the options markets during Limit States and Straddle States and to assess whether the additional protections noted by the Exchange are sufficient safeguards against the submission of erroneous trades, and whether the Exchange's proposal appropriately balances the protection afforded to an erroneous order sender against the potential hazards associated with providing market participants additional time to review trades submitted during a Limit State or Straddle State.

Finally, the Commission notes that the Plan, to which these rules relate, will be implemented on April 8, 2013. Accordingly, for the reasons stated above, and in consideration of the April 8, 2013 implementation date of the Plan, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act,¹³ for approving the Exchange's proposal prior to the 30th day after the publication of the notice in the Federal Register.

the Limit State or Straddle State (or halt if applicable) is 30% away from the price before the start of the Limit State or Straddle State. See MIAX Letter, supra note 4.

¹³ 15 U.S.C. 78s(b)(2). The Commission noticed substantially similar rules proposed by NYSE MKT LLC and NYSE Arca, Inc. with a full 21 day comment period. See Securities Exchange Act Release No. 69033, 78 FR 15067 (March 8, 2013) and Securities Exchange Act Release No. 69032, 78 FR 15080 (March 8, 2013).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁴ that the proposed rule change (SR-MIAX-2013-12), be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁵

Kevin M. O'Neill
Deputy Secretary

¹⁴ 15 U.S.C. 78s(b)(2).

¹⁵ 17 CFR 200.30-3(a)(12).