July 31, 2020

VIA ELECTRONIC DELIVERY

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

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

Dear Ms. Countryman,

Cboe Exchange, Inc. (the "Exchange" or "Cboe Options") appreciates the opportunity to respond to comments submitted on the above-referenced proposed rule change that seeks to allow the Exchange to implement a maximum size of 10 contracts for Agency Orders in S&P 500® Index Options ("SPX") submitted to the Automated Price Improvement Mechanism ("AIM" or "AIM Auction") and the Complex Automated Price Improvement Mechanism ("C-AIM" or "C-AIM Auction") (the "Proposal").[1] The Exchange submits this letter in response to the comment letters received on the Proposal.[2]

The Exchange reiterates that it believes the proposed rule change is consistent with the Securities Exchange Act of 1934, as it will provide retail-sized orders with additional execution and price improvement opportunities and potentially increase retail customer participation in the SPX options market. The Exchange additionally notes that other similar Exchange Rules establish order size thresholds, rules which have been previously filed with the Commission and deemed

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1 The initial proposal would have permitted the Exchange to determine a maximum size, which could be no more than 100 contracts. The Exchange recently submitted Amendment No. 1 to SR-CBOE-2020-051, which among other things specifies that if the Exchange applies a maximum size to SPX Agency Orders submitted to AIM or C-AIM, the maximum size will be 10 contracts.

2 See Letter from Stephen John Berger, Managing Director, Global Head of Government & Regulatory Policy, Citadel Securities to Vanessa Countryman, Secretary, Commission, dated July 9, 2020 ("Citadel Letter"); Letter from Richard J. McDonald, Susquehanna International Group, LLP ("SIG") to Vanessa Countryman, Secretary, Commission, dated July 8, 2020 ("SIG Letter"); Letter from Michael Golding, Head of Trading – Optiver US LLC, and Rutger Brinkhuis, Head of Trading – AMS Derivatives B.V. to Vanessa Countryman, Secretary, Commission, dated July 8, 2020 ("Optiver Letter"); Letter from Ellen Greene, Managing Director, Equities & Options Market Structure, Securities Industry and Financial Markets Association ("SIFMA") to Vanessa Countryman, Secretary, Commission, dated July 9, 2020 ("SIFMA Letter"); and Letter from John S. Markle, Interim General Counsel, TD Ameritrade, Inc. to Vanessa Countryman, Secretary, Commission, dated July 9, 2020 ("TD Letter").

consistent with the Act.[3] The Exchange believes limiting the availability of AIM and C-AIM Auctions to smaller, retail-sized orders will permit the Exchange to provide those orders with these benefits while minimizing any potential negative effects of those auctions on the SPX market.

A Maximum Size for SPX Agency Orders Submitted in AIM and C-AIM Auctions Will Benefit Investors

Several commenters request that the Proposal establish a specific maximum size in the Rules rather than a range.[4] The Exchange recently submitted Amendment No. 1 to the Proposal, which provides that the maximum quantity for all AIM and C-AIM Agency Orders in SPX is 10 contracts. Amendment No. 1 includes additional data to support a maximum size of 10 contracts, which the Exchange believes represents a significant amount of retail activity that would be able to be submitted into AIM and C-AIM if activated for SPX.[5]

The Exchange believes it is reasonable and beneficial to investors to impose a maximum order size for SPX Agency Orders submitted into AIM and C-AIM Auctions rather than activating those auction mechanisms in SPX with no maximum size, contrary to two commenters.[6] The Proposal clearly states why it believes activating AIM and C-AIM in SPX without a maximum size could harm market-maker liquidity in the market,[7] contrary to comments received.[8] The Exchange reiterates its observation of the negative impact of electronic crossing auctions on options market quality, including decreased quoted liquidity on the book, wider quotes, and reduced participation by options market makers.[9] However, the Commission has approved use of electronic crossing auctions, which are now widely used across the options industry. The Exchange has not seen liquidity dynamics or trading protocols prevent this impact in other classes.[10] With the auctions in place, the Exchange continues to focus on cultivating a hybrid market system containing deep liquid markets for investors. Because options orders overwhelmingly trade against Market-Makers, the Exchange aims for a framework that facilitates diverse Market-Maker liquidity provision. In SPX, the Exchange has found that open outcry market-making has been vital to maintaining this framework. The Exchange is concerned that if market participants could submit

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3 See e.g., Rule 5.35(a), which provides that the Exchange may determine the eligible order size for which the Step Up Mechanism ("SUM") auctions may be activated; and Rules 5.39(a)(3) and 5.40(a)(3), which provide that the Exchange may determine a minimum size for Agency Orders submitted to the Solicitation Auction Mechanism ("SAM") and Complex Solicitation Auction Mechanism ("C-SAM") auctions.

4 See TD Letter at 2; Optiver Letter at 1 and 2; and Citadel Letter at 1.

5 If the Exchange determines to impose a different maximum size than 10 contracts, it will propose to do so in a separate rule filing.

6 See SIG Letter at 2 and 4; and Citadel Letter at 2.

7 See Proposal at 4-5 and 9. __.

8 See SIG Letter at 4.

9 The Optiver Letter similarly notes these concerns with respect to electronic crossing auctions in general. See Optiver Letter at 2. The Exchange believes the three primary concerns raised in the Optiver Letter relate to the use of AIM in general rather than the Proposal to include a maximum size. See id. Because the Commission has already approved the use of AIM and C-AIM for all option classes, including SPX, this letter does not respond to those three concerns, as the Exchange could activate AIM and C-AIM in SPX today without a rule filing.

10 See Citadel Letter at 2.

SPX orders of all sizes into electronic crossing auctions, it could have a significant negative impact on the quality of the SPX market, which could reduce overall liquidity in the SPX market and harm all SPX investors. This is why the Exchange historically has not activated these auctions for SPX, and the Proposal now seeks to strike a balance of preserving open outcry liquidity while offering limited electronic auction functionality that some customers found beneficial when available.

The Exchange believes that activating AIM and C-AIM in SPX for a limited number of orders will permit it to make the benefits of these auctions available while limiting any negative impact on market quality by not impacting the majority of order flow in SPX. Larger and more complex orders will continue to execute as they do today on the trading floor and in the electronic book (and thus the Proposal will not curtail any choices of brokers regarding how to handle their customers' orders[11]), which the Exchange believes will incentivize SPX Market-Makers to continue to provide liquidity and tight markets for such orders on the Exchange. Data supports the Exchange's belief that the trading floor may be better for crosses in SPX, contrary to one commenter's statements,[12] as the number of larger and more complicated orders that are crossed on the Exchange was significantly lower when the Exchange closed its trading floor compared to when the trading floor was again open.[13]

<u>The Proposal Is Not Designed To Permit Unfair Discrimination Between Customers, Issuers, Brokers, or Dealers</u>

The Exchange respectfully disagrees with comments that the proposed rule change will unfairly provide certain market participants with benefits that will not be available to other participants.[14] While the Proposal is primarily intended to increase participation in the SPX options market by retail customers (as discussed in the Proposal, customers commonly receive certain benefits in the options industry), the Proposal will impose no restrictions on any market participant's ability to access to AIM and C-AIM Auctions for SPX options. If the Commission approves the Proposal, all market participants will be permitted to submit an Agency Order in SPX containing 10 contracts or fewer through AIM or C-AIM; all market participants may respond to AIM and C-AIM Auctions; and, subject to Commission approval, all market participants may be solicited for contra-

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11 <u>See</u> SIG Letter at 3.

12 <u>See</u> <u>id.</u> at 3.

13 The Exchange observed significantly fewer complex orders with greater numbers of legs in SPX were submitted to C-AIM when the Exchange was temporarily operating in an all-electronic environment, than typically submitted to the trading floor when operating in a normal environment. For example, from January 2 through March 13, 2020 (the last day on which the trading floor was open), complex orders for SPX options with more than six legs represented approximately 5.3% of the total SPX complex order average daily volume ("ADV") during that timeframe. However, from March 16, 2020 (the first day on which the trading floor was closed) through April 30, 2020, complex orders for SPX options with more than six legs represented only approximately 2.2% of the total SPX complex order ADV during that similar timeframe.

14 <u>See</u> SIG Letter at 2-4; and Citadel Letter at 2.

side orders.[15] As a result, the Exchange believes the Proposal promotes just and equitable principles of trade and does not unfairly discriminate between market participants.

In fact, the Proposal would increase market participants' access to AIM and C-AIM Auctions. As noted above, the Exchange currently does not make AIM and C-AIM available in SPX options and only intends to do so with a maximum size if the Commission approves the Proposal. If that occurs, all market participants will continue to have the option to submit orders of all sizes for electronic or open outcry execution in the same manner as they do today, and they will have an additional electronic execution option for their smaller-sized orders. As a result, the Proposal does not remove any choices from the investing public.[16]

The Exchange acknowledges that open outcry and electronic crossing auctions will be available for smaller-sized orders while only open outcry crossing auctions will remain available for larger-sized orders in SPX. While the above-mentioned pending proposed rule change would further align which market participants may participate in the open outcry crossing process with those who may participate in the electronic crossing process, as noted by one commenter,[17] the Exchange believes that it is not possible to completely replicate open outcry trading in an electronic environment, nor does it believe it is always appropriate to do so. In fact, the Exchange does not currently offer an electronic crossing mechanism in SPX options (even though it could), as it does not wish to compromise the diverse Market-Maker pool of SPX liquidity nor the robust Market-Maker competition on the trading floor by allowing all sizes of SPX orders to cross in the electronic auctions and unintendedly drawing Market-Maker liquidity and competition away from open outcry trading.[18]

For the reasons discussed in the Proposal and this letter, the Exchange believes it is beneficial to investors and the SPX market as a whole to not make AIM and C-AIM available to all order sizes. The Proposal delineates that when the Exchange briefly made AIM and C-AIM available in SPX options, beneficial price improvement was generally realized on a greater scale for smaller orders in SPX than for larger orders.[19] The Exchange does not deny that larger orders received price improvement in AIM and C-AIM auctions; however, the Exchange believes the opportunity for this smaller scale price improvement for larger orders, which already take advantage of price improvement opportunities on the trading floor and receive similar price improvement, is

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15 See Securities Exchange Act Release No. 89062 (June 12, 2020), 85 FR 36907 (June 18, 2020) (SR-CBOE-2020-050).

16 See SIG Letter at 4.

17 See SIG Letter at 2.

18 Pursuant to Rule 5.87(f), the Exchange also establishes a different crossing entitlement in open outcry crossing auctions for SPX options (of 40% for facilitated orders but 0% for solicited orders) than would apply in AIM and C-AIM Auctions which is 40% for both facilitated and solicited orders).

19 See Proposal at 18-19.

outweighed by the significant risk to overall SPX market quality if the Exchange activated AIM and C-AIM for orders of all sizes.[20]

Data in the amended Proposal also demonstrates that when AIM and C-AIM are not available for SPX, brokers generally do not cross smaller-sized orders on the trading floor.[21] Instead, smaller-sized orders are generally submitted for electronic execution in the book, where they rest and wait for a marketable order or execute at the market price if marketable upon entry.[22] As such, the Exchange believes the Proposal may mitigate this imbalance of orders that currently realize the benefits of crossing auctions by providing an additional competitive process for smaller-sized orders that brokers rarely attempt to cross on the trading floor.

<u>The Exchange Believes It Is Reasonable To Have a Different Market Model for the SPX Option Class To Address Its Unique Characteristics</u>

The Exchange believes that the characteristics of SPX options make it unique. As a result, the Exchange has and will continue to maintain and update the market model for SPX based on those characteristics. The Exchange has observed that there are fewer smaller orders submitted for execution in the SPX options market, and it understands from customers that this generally relates to unique characteristics of SPX options. The Exchange believes one commenter mischaracterizes several statements the Exchange makes in the Proposal regarding SPX options. The Exchange does not believe the specific factors of SPX limit retail participation to simpler strategies and smaller-sized orders within the confines of the class itself.[23] Instead, the Exchange understands retail customers generally submit simpler and smaller orders compared to those submitted by institutional investors in any class. The Exchange believes the specific factors of SPX, particularly given the large notional value of SPX options compared to other products, can limit retail participation in the SPX market in general rather than the size of retail SPX orders. Therefore, the Proposal is not intended to limit the size of retail orders submitted into electronic crossing auction but instead is intended to limit the number of orders (*i.e.*, limit to "retail-sized" orders) that may be submitted into these auctions to protect overall market liquidity and quality.[24]

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[20] The Exchange notes too that one commenter observed that its clients' smaller SPX orders had noticeably benefited from the AIM and C-AIM program, whereas the benefits were not as consistent for its clients' larger-sized orders. <u>See</u> TD Letter at 1-2.

[21] <u>See</u> Amendment No. 1 at 7-8.

[22] Based on this, it appears that brokers believe it is currently consistent with their best execution obligations to route orders for electronic execution as opposed to attempt to cross them on the trading floor, contrary to statements from a commenter. <u>See</u> SIG Letter at 2.

[23] <u>See</u> <u>id.</u> at 2 and 3. <u>See</u> <u>also</u> Proposal at 4, and Amendment No. 1 at 24. SIG incorrectly surmises that this is the Exchange's belief. However, this statement is taken out of context, wherein the Proposal and its amendment, it is clear from the surrounding language that the Exchange understands that retail participation in SPX is generally limited as compared to retail participation in other classes.

[24] In other words, the Exchange does not believe retail order flow into electronic auctions is "self-limiting" in size, as suggested by one commenter. <u>See</u> <u>id.</u>

<u>The Proposal, As Amended, Includes Sufficient Data to Support a Maximum Size of 10 Contracts</u>

Certain commenters questioned the sufficiency and applicability of the data presented in the Proposal.[25] Specifically, those commenters stated that the data in the Proposal is from a brief period of extreme volatility when the trading floor was unavailable and thus provides limited support for a maximum AIM and C-AIM order size. The Exchange disagrees. The sample data was from a randomly selected short time period within the brief time that any SPX AIM and C-AIM data was available. All order sizes submitted into AIM and C-AIM during that time would have been similarly impacted by any then-existing volatility, making the data sample an accurate comparison of price improvement opportunities for orders of all sizes executed in those auctions during that time. Because orders represented on the trading floor are "not held" and thus handled by brokers as market orders, the Exchange is unable to accurately demonstrate "price improvement" for orders executed on the trading floor as it can for orders executed in electronic auctions, for which the Exchange can demonstrate price improvement over the starting auction price. However, two commenters agree with the data in the Proposal, stating that smaller orders in general received more improvement when AIM and C-AIM were activated than when they are not activated.[26]

Amendment No. 1 also presents data drawn from a two-month time period of "normal trading conditions," which shows that when AIM and C-AIM were activated for SPX, a larger number of SPX orders for 10 contracts or fewer were submitted into the electronic crossing auctions compared to larger-sized orders.[27] Once the trading floor became operable and the Exchange disabled AIM and C-AIM for SPX, the volume of customer orders in SPX for 10 or fewer contracts submitted into crossing auctions (on the trading floor) decreased significantly[28] compared to the volume previously submitted into the electronic auctions, while larger order sizes experienced a notable increase in crossed volume compared to volume submitted into electronic auctions.

The Exchange reiterates that the Proposal is intended to permit the Exchange to make electronic crossing auctions available in SPX options in a limited manner that will have minimal impact on the market quality of the class, which the Exchange believes will benefit all investors in the SPX market. The Exchange appreciates the opportunity to respond to comments on the Proposal and urges the Commission to approve it in a timely manner. Please feel free to contact myself at [redacted] if you have any questions related to this matter.

Respectfully submitted,

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25 <u>See</u> SIG Letter at 3 and 4; and Optiver Letter at 2.
26 <u>See</u> TD Letter at 1; and SIFMA Letter at 2.
27 <u>See</u> Amendment No. 1 at 7.
28 <u>See</u> <u>id</u>. The Exchange observed an approximate 99% decrease in number simple orders and number of complex orders containing ten or fewer contracts.

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