Lakeshore Securities L.P.

XFA
A DIVISION OF MAREX

July 12, 2022

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington DC 20549

Re: SR-CBOE-2022-027

The undersigned Cboe Trading Permit Holders (TPHs) appreciate the opportunity to comment on the Cboe Exchange, Inc.'s (Cboe) proposal to amend Cboe Rule 5.4 to reduce the minimum increment in most VIX options traded on the Cboe trading floor from $0.05 ("nickel increment") to $0.01 ("penny increment"). Lakeshore Securities, L.P. ("Lakeshore") and X-Change Financial Access LLC ("XFA") represent the two largest open outcry brokers and facilitators in the VIX options at Cboe. We believe that the proposal to implement penny increments has substantial potential to reduce liquidity in the VIX options and, furthermore, has substantial potential to create regulatory issues for market participants.

Accordingly, the proposed amendment to Cboe Rule 5.4 reducing the minimum increment in VIX options should not be adopted as a "non-controversial" proposed rule change but should be the subject of additional review and consideration prior to any adoption.

I. Potential to Harm Liquidity. As long-time participants in the VIX options market, we believe that the proposed rule change has substantial potential to reduce liquidity by fragmenting the quantities bid or offered at the current nickel increments among penny increments. We believe that one important reason for the success of the VIX option has been the deep liquidity at every price level. Because of this, large market participants are confident that their orders will be executable at a single price. If penny increments are adopted, orders that are currently resting at the existing nickel increments will be fragmented. For larger market participants, this will mean greater uncertainty as orders may be executed at two, three or four different penny increments. We believe that there is a substantial possibility that this will cause larger market participants to find the Cboe VIX options less attractive and to migrate to the use of "look-alike" VIX option products traded over the counter.

   As noted elsewhere, the Cboe appears to believe that the move to penny increments will appeal to retail investors. We are skeptical that the penny increments will appeal to or attract retail interest. Generally speaking, retail traders have not traded the VIX option contract. Rather, retail interest has historically been concentrated in the VXX and VXX options. A previous attempt by the Cboe to generate interest among retail in the VIX suite of products was tried when mini-VIX futures contracts (the VXM futures contract) were launched on the Cboe Futures Exchange ("CFE") in August 2020. Nearly two years later, these mini-VIX futures contracts have not found much interest with retail investors and typically trade only a few thousand contracts per day.

Not only has there been little success in drawing retail interest to VIX products to date, but even if attempts to attract retail to VIX had worked, it is our view that what appeals to retail investors is unlikely to appeal to institutional investors in the long run. We believe that the loss of institutional investor interest will substantially outweigh any new retail participants if penny increments are adopted (whether temporarily or permanently). Any resulting loss of liquidity can only be harmful to the VIX options market as a whole.

We believe that a move to penny increments will substantially reduce the number of large orders entered in VIX options since algorithmic traders will instantly detect these orders and will "lean" on such larger orders. The only defense for institutional customers to avoid having algorithmic traders "lean" on them will be to reduce the size of orders, leading to a reduction in liquidity.

II. The Proposed Amendment is Unlikely to Produce the Claimed Benefit. In its submission, the Cboe states that:

> "[The Cboe] believes market demand (including by retail investors, who generally prefer lower trading increments) supports a lower trading increment for these series. The Exchange expects this more granular pricing to lead to narrowing of the bid-ask spread for these options and increase the possible number of price points available to investors for these series. The Exchange believes tighter spreads will increase order flow in VIX options, which additional liquidity ultimately benefits all investors." *See Release No. 34-95102 (June 14, 2022) at page 4.*

While the Cboe speculates that "tighter spreads will increase order flow" and lead to "additional liquidity", it is at least as likely that any appearance of additional liquidity will be just that – an appearance. We believe that any increase in liquidity will be due to increases in high frequency algorithmic order flow into VIX. Such order flow is often "junk liquidity" meaning that there is an illusion of order depth is created but the depth disappears in literal microseconds if a market participant seeks to execute against it.

III. Potential for Increased Number of Regulatory Issues. The proposed amendment notes that approximately 62% of VIX option contract volume is currently executed as part of "complex orders." Complex orders are defined as "as an order for two or more different options series "legs" sent to the exchange as a single order. The order, if filled is guaranteed to execute with a net price and ratio, unlike sending two or more individual orders." *See* US Options Complex Book Process, Version 1.2.37 (Cboe Exchange, June 3, 2022, available at: https://cdn.cboe.com/resources/membership/US-Options-Complex-Book-Process.pdf). Complex orders may have as many as twelve legs.[1] Brokers executing a complex order are obligated to price all legs of the complex order within the existing best bid or offers. If the penny increment proposed amendment were to be adopted, there will be great potential for small orders to rest in the electronic book with only a penny increment separating the best bid from the best offer. Under certain circumstances, a broker is permitted to price a leg of a complex order so that it matches the best bid or offer. However, as the number of legs in a complex order increases, it becomes harder and harder for a broker to "fit" prices that delivers to the customer the net price desired. If a broker is unable to "fit" prices within existing bids and offers, the execution of the spread is said to be "blocked." If penny increments are adopted, we anticipate that we will see a substantial increase in (i) the number of complex spreads which cannot be executed because the pricing is "blocked"; and (ii) the number of inadvertent "trade throughs" occurring.[2] We believe that institutional investors who are regularly unable to obtain execution of their complex VIX spread orders on Cboe will leave the Cboe VIX option market.

We appreciate the opportunity to voice our concerns regarding the proposed VIX penny increment amendment to Cboe Rule 5.4. If you have any questions regarding our comments or wish to further discuss any of these issues, please do not hesitate to contact any of the undersigned.

Very truly yours,

LAKESHORE SECURITIES, L.P.

/s/ *Matthew Filpovich*
Partner

/s/ *David Downs*
Partner

X-CHANGE FINANCIAL ACCESS, LLC

/s/ *William V. Looney, Jr.*
Head of Global Business Development

/s/ *William J. Ellington*
Chief Executive Officer – Securities Division

[1] Additionally, "cash spreads" (where the spread is priced on a total cash limit priced on the notional value of the order), have **no** limit on the number of number of legs that may be included in the order.
[2] A "trade through" occurs when price is quoted that is lower than a bid resting in the electronic book or higher than an offer resting in the electronic book. This represents a regulatory violation, even though no simple order actually traded (or could have traded) at the applicable price.