

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-84436; File No. SR-CBOE-2018-062)

October 16, 2018

Self-Regulatory Organizations; Cboe Exchange, Inc.; Order Approving a Proposed Rule Change to Amend Rule 6.2, Interpretation and Policy .01, Concerning Strategy Orders

I. Introduction

On August 24, 2018, Cboe Exchange, Inc. (“Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposal to amend Exchange Rule 6.2, Interpretation and Policy .01, concerning strategy orders. The proposed rule change was published for comment in the Federal Register on September 12, 2018.<sup>3</sup> The Commission received no comment letters regarding the proposed rule change. This order approves the proposed rule change.

II. Description of the Proposed Rule Change

Exchange Rule 6.2, Interpretation and Policy .01 sets forth the modified Hybrid Opening System (“HOSS”) procedure for the option series used to calculate the exercise or final settlement value for expiring volatility index derivatives.<sup>4</sup> As described in the Notice,<sup>5</sup> the Exchange notes that market participants seeking to replicate the exposure of their expiring VIX derivatives generally do so with portfolios of constituent SPX options referred to as “strategy orders,” which they submit for

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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. 84045 (September 12, 2018), 83 FR 46230 (“Notice”).

<sup>4</sup> See proposed Exchange Rule 6.2, Interpretation and Policy .01(a). These volatility indexes include the Cboe Volatility Index (“VIX”) and the Russell 2000 Volatility Index. See Notice, supra note 3, at 46232, n.3.

<sup>5</sup> See note 3, supra.

execution in the modified HOSS opening procedure on VIX exercise settlement value determination days.<sup>6</sup> As with any opening auction, the entry of such strategy orders may lead to order imbalances in the constituent option series, which is noteworthy because such series are used to determine the exercise settlement value of the expiring VIX derivatives.<sup>7</sup> Consequently, the Exchange currently imposes a cut-off time by which such strategy orders, or changes to such orders, must be received.

The Exchange believes that, in the past, some market participants that have submitted strategy orders prior to the strategy order cut-off time<sup>8</sup> may have refrained from entering orders to offset imbalances after the strategy order cut-off time because of the perceived risk that their orders may be deemed to be a new strategy order or a change to an existing strategy order, which are not permitted under the Exchange's rules after the strategy order cut-off time.<sup>9</sup> As a result, the Exchange believes that the possible non-participation in the opening auction of firms that have

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<sup>6</sup> See Notice, supra note 3, at 46232-3. The exercise settlement value determination day is a day on which the Exchange determines the exercise or final settlement value, as applicable, of expiring volatility index derivatives. See proposed Exchange Rule 6.2, Interpretation and Policy .01(a). The Exchange notes that because market participants use strategy orders to convert vega (volatility) exposure from one instrument (expiring VIX derivative) to another (portfolio of SPX options expiring in 30 days), the market participant is likely to be indifferent to the settlement price received for the expiring VIX derivatives. See Notice, supra note 3, at 46233. The Exchange further explained that “[s]ince VIX derivatives expire 30 days prior to the SPX options used to calculate their settlement value, a market participant may have a vega risk from its portfolio of index positions that the participant wants to continue to hedge after the participant’s VIX derivatives expire. To continue that vega coverage following expiration of a VIX derivative, a market participant may determine to trade the portfolio of SPX options used to calculate the exercise settlement value of an expiring VIX derivative, since those SPX options still have 30 more days to expiration. This trade essentially replaces the uncovered vega exposure “hole” created by an expiring VIX derivative.”).

<sup>7</sup> See Notice, supra note 3, at 46233. Generally, if a series (1) has a market order imbalance, or (2) is at a price that is outside the Exchange prescribed opening width (as described in Exchange Rule 6.2(d)), the series will not open for trading. See id.

<sup>8</sup> The strategy order cut-off time is currently set as 8:20 a.m. Chicago time. See Notice, supra note 3, at 46236.

<sup>9</sup> See id. at 46235.

submitted strategy orders could impact liquidity at the opening on exercise settlement value determination days and increase the risk that some series do not open because of an imbalance.<sup>10</sup>

To address these concerns, the proposal modifies the definitions of strategy order and non-strategy order to provide more guidance to market participants.<sup>11</sup>

The proposal revises the definition of strategy order to provide that individual orders (considered collectively) that a market participant submits for participation in the modified opening procedure on exercise settlement value determination days generally are considered to be a strategy order if they: (1) relate to the market participant's positions in expiring volatility index derivatives; (2) are for option series with the expiration that the Exchange will use to calculate the exercise or final settlement value, as applicable, of the applicable volatility index derivative; (3) are for option series with strike prices approximating the range of series that are later determined to constitute the constituent option series<sup>12</sup> for the applicable expiration; (4) are for put (call) options with strike prices equal to or less (greater) than the "at-the-money" strike price; and (5) have quantities

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<sup>10</sup> See Notice, supra note 3, at 46235.

<sup>11</sup> The proposal retains the existing requirement that market participants submit strategy orders prior to the strategy order cut-off time and continues to prohibit a change to or cancellation of a strategy order after the strategy order cut-off time, except as provided in proposed Exchange Rule 6.2, Interpretation and Policy .01(c)(2). See proposed Exchange Rule 6.2, Interpretation and Policy .01(c). The proposal also adds the new defined terms volatility index derivatives, exercise settlement value determination day, and constituent option series; places all of the defined terms used in Exchange Rule 6.2, Interpretation and Policy .01 in paragraph (a) of that rule; and makes several non-substantive changes to Interpretation and Policy .01.

<sup>12</sup> The constituent option series are all of the options series that are used to calculate the exercise or final settlement value, as applicable, of expiring volatility index derivatives. See proposed Exchange Rule 6.2, Interpretation and Policy .01(a).

approximating the weighting formula used to determine the exercise or final settlement value, as applicable, in accordance with the applicable volatility index methodology.<sup>13</sup>

Conversely, the proposal defines a non-strategy order to mean any order (including an order in a constituent option series) a market participant submits for participation in the modified opening procedure on exercise settlement value determination days that is not a strategy order (or a change to or cancellation of a strategy order).<sup>14</sup> In its filing, the Exchange provided examples of non-strategy orders, including: (1) a buy (sell) order in a constituent options series if an expected opening information message (“EOI”) is disseminated no more than two minutes prior to the time a market participant submitted the order included a sell (buy) imbalance and the size of the order is no larger than the size of the imbalance in the EOI, regardless of whether the market participant previously submitted a strategy order or has positions in expiring volatility index derivatives; or (2) a Market-Maker bid or offer in a constituent option series, as set forth in Exchange Rule 6.2, Interpretation and Policy .01(e).<sup>15</sup> The Exchange stated that its definition of non-strategy order is designed to encourage all market participants to enter orders following the strategy order cut-off time for the purpose of offsetting disseminated imbalances in the constituent option series, regardless of whether the market participant previously submitted a strategy order.<sup>16</sup>

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<sup>13</sup> See proposed Exchange Rule 6.2, Interpretation and Policy .01(a).

<sup>14</sup> See id.

<sup>15</sup> See id. The proposal renumbers current Exchange Rule 6.2, Interpretation and Policy .01(c) as .01(e).

<sup>16</sup> See Notice, supra note 3, at 46235. The Exchange determines the non-strategy order cut-off time on a class-by-class basis, which may be no earlier than 8:25 a.m. and no later than the opening of trading in a series. The Exchange will announce any changes to the non-strategy order cut-off time at least one day prior to implementation. See proposed Exchange Rule 6.2, Interpretation and Policy .01(d). The Exchange has set the non-strategy order cut-off time to be the opening of trading. See Notice, supra note 3, at 46236.

The Exchange notes the proposed rule change would not impact a Trading Permit Holder's ("TPH") requirements to abide by Exchange Rules 4.1 (Just and Equitable Principles of Trade), 4.7 (Manipulation), and 4.18 (Prevention of the Misuse of Material, Nonpublic Information).<sup>17</sup> In addition, the Exchange will continue to conduct surveillance to monitor trading in the constituent option series, including but not limited to compliance with the strategy order cut-off time.<sup>18</sup>

### III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act,<sup>19</sup> and the rules and regulations thereunder applicable to a national securities exchange.<sup>20</sup> In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,<sup>21</sup> which requires, among other things, that the rules of a national securities exchange be designed 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, and that the rules are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

The Commission believes that by more clearly identifying what constitutes a strategy order, and by defining a non-strategy order to include, among other things, orders in a constituent option series that offset an imbalance identified in an EOI, as described above, the proposed rule change could encourage market participants to submit orders that offset imbalances in constituent option

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<sup>17</sup> See id.

<sup>18</sup> See id.

<sup>19</sup> 15 U.S.C. 78f.

<sup>20</sup> 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).

<sup>21</sup> 15 U.S.C. 78f(b)(5).

series, thereby reducing the likelihood that a constituent option series will fail to open due to an order imbalance. By reducing the likelihood that constituent option series will fail to open, the proposal is reasonably designed to facilitate an orderly opening for volatility index derivatives. Nevertheless, the Commission remains mindful of the potential for disruptive or manipulative trading to occur in connection with the opening process in constituent options series on exercise settlement value determination days for volatility index options. The Commission believes that the proposal provides narrowly tailored guidance to market participants to promote participation in the modified HOSS opening procedure on exercise settlement value determination days in a manner that is reasonably designed to support orderly trading in a free and open market, which can benefit investors in those constituent options series and the volatility index derivatives.

Further, the Commission notes that TPHs will continue to be subject to Exchange Rules 4.1 (Just and Equitable Principles of Trade), 4.7 (Manipulation), and 4.18 (Prevention of the Misuse of Material, Nonpublic Information).<sup>22</sup> In addition, the Exchange will continue to conduct surveillance to monitor trading in the constituent option series,<sup>23</sup> which the Commission believes is essential to protect investors and the public interest.

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<sup>22</sup> See Notice, supra note 3, at 46236.

<sup>23</sup> See id.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>24</sup> that the proposed rule change (SR-CBOE-2018-062) is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>25</sup>

Eduardo A. Aleman  
Assistant Secretary

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<sup>24</sup> 15 U.S.C. 78s(b)(2).

<sup>25</sup> 17 CFR 200.30-3(a)(12).