

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-84364; File No. SR-NYSEAMER-2018-39)

October 4, 2018

Self-Regulatory Organizations; NYSE American LLC; Notice of Filing of Proposed Rule Change to Allow Flexible Exchange Equity Options Where the Underlying Security is an Exchange-Traded Fund that is Included in the Option Penny Pilot to be Settled in Cash

Pursuant to Section 19(b)(1)¹ of the Securities Exchange Act of 1934 (“Act”)² and Rule 19b-4 thereunder,³ notice is hereby given that on September 20, 2018, NYSE American LLC (“NYSE American” or the “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to amend certain rules related to Flexible Exchange (“FLEX”) Options. The proposed rule change is available on the Exchange’s website at www.nyse.com, at the principal office of the Exchange, and at the Commission’s Public Reference Room.

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of those statements may be examined at the places

¹ 15 U.S.C.78s(b)(1).

² 15 U.S.C. 78a.

³ 17 CFR 240.19b-4.

specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant parts of such statements.

A. Self-Regulatory Organization’s Statement of the Purpose of, and the Statutory Basis for, the Proposed Rule Change

1. Purpose

The purpose of this filing is to amend certain rules related to FLEX Options, as described below.

FLEX Options are customized equity or index contracts that allow investors to tailor contract terms for exchange-listed equity and index options.⁴ The Exchange is proposing to modify rules to offer an alternative settlement for certain FLEX Equity Options.⁵ As proposed, FLEX Equity Options where the underlying security is an Exchange-Traded Fund (“ETF”) that is included in the Option Penny Pilot⁶ (“FLEX ETF Penny Option”) would be settled by physical delivery of the underlying ETF or by delivery in cash. Currently, all FLEX Equity Options are settled by physical delivery of the underlying security.⁷ All FLEX Index Options, however, are currently settled by delivery in cash.⁸

⁴ See generally Section 15, Flexible Exchange Options, Rules 900G-910G.

⁵ The term “FLEX Equity Option” means an option on a specified underlying security that is subject to the rules in Section 15, Flexible Exchange Options Rules. See Rule 900G(b)(10).

⁶ See Securities and Exchange Act Release No. 55162 (January 24, 2007), 72 FR 4738 (February 1, 2007) (SR-Amex-2006-106). The Option Penny Pilot has been extended numerous times and remains operational through December 31, 2018. See Securities Exchange Act Release No. 83507 (June 25, 2018), 83 FR 30808 (June 29, 2018) (SR-NYSEAMER-2018-33).

⁷ See Rule 903G(c)(3)(i).

⁸ See Rule 903G(b)(2) and (3).

To effectuate this change, the Exchange proposes to adopt new Rule 903G(c)(3)(ii)⁹ which would provide that the exercise settlement for a FLEX ETF Penny Option shall be by physical delivery of the underlying security or by delivery in cash.¹⁰ The proposed rule also adopts a definition of the term FLEX ETF Penny Option for purpose of Rule 903G(3) to mean a FLEX Equity Option whose underlying security is an ETF that is included in the Option Penny Pilot.¹¹ The Exchange believes it is appropriate to introduce cash-settlement as an alternative to this group of equity securities because ETFs generally have increasingly become a major part of investors' portfolio. The vast proliferation of ETFs has greatly expanded the ability of investors to take advantage of many unique opportunities to hedge their portfolio and manage risk. Investors can take long and/or short positions - as well as in many cases, leveraged long or short positions - in baskets of securities whose components can include foreign and domestic stock indexes, currencies, commodities and bonds. Over the years, ETFs have also attracted a great deal of options trading.

Today, all ETF options are settled physically, i.e., upon exercise, shares of the underlying ETF must be assumed or delivered. Physical settlement possesses certain risks with respect to volatility and movement of the underlying security at expiration that market participants may need to hedge against. Cash settlement does not present the same risk. If an issue with the delivery of the underlying security arises, it may become more expensive (and time consuming) to reverse the delivery because the price of the underlying security would almost certainly have changed. Reversing a cash payment, on the other hand, would not involve any such issue

⁹ The Exchange proposes a non-substantive amendment to Rule 903G to renumber current Rule 903G(c)(3)(ii) as new Rule 903G(c)(3)(iii).

¹⁰ See proposed Rule 903G(c)(3)(ii).

¹¹ Id.

because reversing a cash delivery would simply involve the exchange of cash. Additionally, with physical settlement, market participants that have a need to generate cash would have to sell the underlying security while incurring the costs associated with liquidating their position in the underlying security as well as the risk of an adverse movement in the price of the underlying security. The Exchange notes that cash settlement for options is not a unique feature and other options exchanges currently trade cash-settled options.¹²

The Exchange understands that there are concerns that have been raised in the past regarding cash-settled equity options. The Exchange seeks to allay such concerns by proposing to adopt cash-settlement as an alternative to ETFs only, and more specifically, to a narrow universe of ETFs, i.e., ETFs that are in the Option Penny Pilot. As a general matter, all index options traded today are cash-settled and derive their value from a disseminated index price. Similarly, ETFs typically have their values linked to a disseminated index price. As noted above, the Exchange seeks to limit cash-settlement to a subset of ETFs which are the most actively traded, as evidenced by their inclusion in the Option Penny Pilot. The Options Penny Pilot is an ongoing pilot program that, since 2007, allows certain option classes to be quoted in reduced price increments compared to all other option classes. More specifically, the Option Penny Pilot specifies that options trading at less than \$3.00 have trading increment of one cent, while those trading at \$3.00 or more have trading increments of five cents. There are currently 363 classes in the Options Penny Pilot. Each class added to the original pilot was chosen

¹² See e.g. PHLX FX Options traded on Nasdaq PHLX and S&P 500® Index Options traded on Cboe Options Exchange. More recently, the Commission approved, on a pilot basis, the listing and trading of RealDay™ Options on the BOX Options Exchange LLC. See Securities Exchange Act Release No. 79936 (February 2, 2017), 82 FR 9886 (February 8, 2017) (“RealDay Pilot Program”). The RealDay Pilot Program has been extended until February 2, 2019. See Securities Exchange Act Release No. 82414 (December 28, 2017), 83 FR 577 (January 4, 2018) (SR-BOX-2017-38).

because it was one of the “most actively-traded multiply-listed options classes.” Upon the last expansion of the pilot, the specific 300 most-active classes were identified based on the underlying security’s “national average daily volume over a six-month period” thereby ensuring that the Option Penny Pilot continues to include only those classes that are actively traded.

There are currently only 64 ETFs in the Option Penny Pilot that would be subject to the proposed rule change.

With respect to position limits, cash-settled FLEX ETF Penny Options will be subject to the position limits set forth in Rule 906G. Accordingly, the Exchange would establish position limits for cash-settled FLEX ETF Penny Options that are the same as non-cash-settled FLEX ETF Penny Options.

The Exchange understands that FLEX ETF Penny Options are currently traded in the over-the-counter (“OTC”) market by a variety of market participants, e.g., hedge funds, proprietary trading firms, and pension funds, to name a few. The Exchange believes there is room for significant growth if a comparable product were introduced for trading on a regulated market. The Exchange expects that users of these OTC products would be among the primary users of exchange-traded cash-settled FLEX ETF Penny Options. The Exchange also believes that the trading of cash-settled FLEX ETF Penny Options would allow these same market participants to better manage the risk associated with the volatility of underlying ETF positions given the enhanced liquidity that an exchange-traded product would bring.

Cash-settled FLEX ETF Penny Options traded on the Exchange would have three important advantages over the contracts that are traded in the OTC market. First, as a result of greater standardization of contract terms, exchange-traded contracts should develop more liquidity. Second, counter-party credit risk would be mitigated by the fact that the contracts are

issued and guaranteed by The Options Clearing Corporation (“OCC”). Finally, the price discovery and dissemination provided by the Exchange and its members would lead to more transparent markets. The Exchange believes that its ability to offer cash-settled FLEX ETF Penny Options would aid it in competing with the OTC market and at the same time expand the universe of products available to interested market participants. The Exchange believes that an exchange-traded alternative may provide a useful risk management and trading vehicle for market participants and their customers.

The Exchange has confirmed with the OCC that OCC can support the clearance and settlement of cash-settled FLEX ETF Penny Options. The Exchange has analyzed its capacity and represents that it believes the Exchange and OPRA have the necessary systems capacity to handle the additional traffic associated with the listing of cash-settled FLEX ETF Penny Options. The Exchange believes any additional traffic that would be generated from the introduction of cash-settled FLEX ETF Penny Options will be manageable. The Exchange believes ATP Holders will not have a capacity issue as a result of this proposed rule change. The Exchange also represents that it does not believe this proposed rule change will cause fragmentation of liquidity. The Exchange will monitor the trading volume associated with the additional options series listed as a result of this proposed rule change and the effect (if any) of these additional series on market fragmentation and on the capacity of the Exchange's automated systems.

The Exchange has an adequate surveillance program in place for cash-settled FLEX ETF Penny Options and intends to apply the same program procedures that it applies to the Exchange’s other options products. FLEX options products and their respective symbols are integrated into the Exchange’s existing surveillance system architecture and are thus subject to the relevant surveillance processes. As a result, the Exchange believes it would be able to

effectively police the trading of cash-settled FLEX ETF Penny Options using means that include its surveillance for manipulation. The Exchange believes that manipulating the settlement price of cash-settled FLEX ETF Penny Options would be difficult based on the size of the market for such ETFs. Additionally, the Exchange notes that each cash-settled FLEX ETF Penny Option that would be subject to this proposed rule change is sufficiently active so as to alleviate concerns about potential manipulative activity. Further, the vast liquidity of ETF options as well as the underlying equities markets ensures a multitude of market participants at any given time. Given the high level of participation among market participants that enter quotes and/or orders in ETF options, the Exchange believes it would be very difficult for a single participant to alter the prices of each of the underlying securities of an ETF in any significant way without exposing the would-be manipulator to regulatory scrutiny. The Exchange further believes any attempt to manipulate the prices of the underlying securities of an ETF would also be cost prohibitive.

Additionally, the Exchange is a member of the Intermarket Surveillance Group (“ISG”) under the Intermarket Surveillance Group Agreement dated June 20, 1994. The ISG members work together to coordinate surveillance and investigative information sharing in the stock and options markets. For surveillance purposes, the Exchange would therefore have access to information regarding trading activity in the pertinent underlying securities.

The Exchange believes that introducing cash-settled FLEX ETF Penny Options would further broaden the base of investors that use FLEX Options to manage their trading and investment risk, including investors that currently trade in the OTC markets for customized options, where settlement restrictions do not apply. The proposed rule change is also designed to encourage market makers to shift liquidity from OTC markets onto the Exchange, which, it believes, will enhance the process of price discovery conducted on the Exchange through

increased order flow. The Exchange also believes that this may open up cash-settled FLEX ETF Penny Options to more retail investors. The Exchange does not believe that this raises any unique regulatory concerns because existing safeguards—such as position limits, exercise limits, and reporting requirements—would continue to apply.

2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Securities Exchange Act of 1934 (the “Act”),¹³ in general, and furthers the objectives of Section 6(b)(5) of the Act,¹⁴ in particular, in that it is 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. Specifically, the Exchange believes that introducing cash-settled FLEX ETF Penny Options will increase order flow to the Exchange, increase the variety of options products available for trading, and provide a valuable tool for investors to manage risk.

The Exchange believes that the proposal to add cash-settled FLEX ETF Penny Options would remove impediments to and perfect the mechanism of a free and open market as cash-settled FLEX ETF Penny Options would enable market participants to receive cash in lieu of shares of the underlying security, which would, in turn provide greater opportunities for market participants to manage risk through the use of cash-settled FLEX ETF Penny Options to the benefit of investors and the public interest.

The Exchange believes that the proposal to permit cash settlement would remove impediments to and perfect the mechanism of a free and open market because the proposed rule

¹³ 15 U.S.C. 78f(b).

¹⁴ 15 U.S.C. 78f(b)(5).

change would provide OTP [sic] Holders with enhanced methods to manage risk by receiving cash if they choose to do so instead of the underlying security. In addition, this proposal would promote just and equitable principles of trade and protect investors and the general public because cash settlement would provide investors with an additional tool to manage their risk. Further, the Exchange notes that its proposal to introduce cash-settled FLEX ETF Penny Options is not novel in that other exchanges currently offer [sic] cash settlement for options whose underlying security is an ETF. The proposed rule change therefore should not raise any issues for the Commission that have not been previously addressed.¹⁵

The proposed rule change to permit cash-settled FLEX ETF Penny Options is designed to promote just and equitable principles of trade in that the availability of cash-settled FLEX ETF Penny Options will give market participants an alternative to trading similar products in the OTC market. By trading a product in an exchange-traded environment (that is currently being used in the OTC market), the Exchange will be able to compete more effectively with the OTC market. The Exchange believes the proposed rule change is designed to prevent fraudulent and manipulative acts and practices in that it will hopefully lead to the migration of options currently trading in the OTC market to trading to the Exchange. Also, any migration to the Exchange from the OTC market will result in increased market transparency. Additionally, the Exchange believes the proposed rule change is designed to remove impediments to and to perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest in that it should create greater trading and hedging opportunities and flexibility. The proposed rule change should also result in enhanced efficiency in initiating and closing out positions and heightened contra-party creditworthiness due to the role of OCC as

¹⁵ See supra note 12.

issuer and guarantor of cash-settled FLEX ETF Penny Options. Further, the proposed rule change will result in increased competition by permitting the Exchange to offer products that are currently used in the OTC market.

Finally, the Exchange represents that it has an adequate surveillance program in place to detect manipulative trading in cash-settled FLEX ETF Penny Options. Regarding the proposed cash settlement, the Exchange would use the same surveillance procedures currently utilized for the Exchange's other FLEX Options. For surveillance purposes, the Exchange would have access to information regarding trading activity in the pertinent underlying securities. The Exchange believes that limiting cash settlement to FLEX ETF Penny Options will minimize the possibility of manipulation due to the robust liquidity in both the ETF and options markets.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposal is designed to increase competition for order flow on the Exchange in a manner that is beneficial to investors because it is designed to provide investors seeking to effect cash-settled FLEX ETF Penny Option orders with the opportunity for different methods of settling option contracts at expiration.

The Exchange notes that it operates in a highly competitive market in which market participants can readily direct order flow to competing venues who offer similar functionality. The Exchange believes the proposed rule change encourages competition amongst market participants to provide tailored cash-settled FLEX ETF Penny Option contracts.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

No written comments were solicited or received with respect to the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or up to 90 days (i) as the Commission may designate if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- (A) by order approve or disapprove the proposed rule change, or
- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. 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. Please include File Number SR-NYSEAMER-2018-39 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.

All submissions should refer to File Number SR-NYSEAMER-2018-39. 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 such 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-NYSEAMER-2018-39, and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁶

Eduardo A. Aleman
Assistant Secretary

¹⁶ 17 CFR 200.30-3(a)(12).