

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-84870; File No. SR-NYSEAMER-2018-39)

December 19, 2018

Self-Regulatory Organizations; NYSE American LLC; Order Instituting Proceedings To Determine Whether To Approve or Disapprove a 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

I. Introduction

On September 20, 2018, NYSE American LLC (“NYSE American” or the “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to modify the rules related to Flexible Exchange (“FLEX”) Options to allow FLEX Equity Options where the underlying security is an Exchange-Traded Fund (“ETF”) that is included in the Option Penny Pilot to be settled in cash.³ The proposed rule change was published for comment in the Federal Register on October 11, 2018.⁴ On November 19, 2018, pursuant to Section 19(b)(2) of the Act,⁵ the Commission designated a longer period within which to either approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to disapprove the proposed rule change.⁶ The Commission

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ For the definitions of “FLEX Options,” “FLEX Equity Options,” and “Option Penny Pilot,” see infra notes 9 and 11.

⁴ See Securities Exchange Act Release No. 84364 (October 4, 2018), 83 FR 51535 (October 11, 2018) (“Notice”).

⁵ 15 U.S.C. 78s(b)(2).

⁶ See Securities Exchange Act Release No. 82994 (April 4, 2018), 83 FR 15441 (April 10, 2018). The Commission designated January 9, 2019, as the date by which it should approve, disapprove, or institute proceedings to determine whether to disapprove the proposed rule change.

received one comment on the proposed rule change.⁷ This order institutes proceedings under Section 19(b)(2)(B) of the Act⁸ to determine whether to approve or disapprove the proposed rule change.

II. Description of the Proposal and Comments Received

The Exchange has proposed to amend NYSE American Rule 903G(c) to allow for cash settlement for certain FLEX Equity Options.⁹ Currently, FLEX Equity Options settle by physical delivery of the underlying security.¹⁰ The Exchange proposes, in the case of a FLEX Equity Option whose underlying security is an ETF that is included in the Option Penny Pilot¹¹ (“FLEX ETF Option”), to allow settlement either by the delivery of cash or, as currently permitted under the Exchange rules, by physical delivery of the underlying security.¹²

The Exchange states that it believes that it is appropriate to introduce cash settlement as an alternative for FLEX ETF Options because ETFs generally have increasingly become a major

⁷ See Letter to Brent J. Fields, Secretary, Commission, from Samara Cohen, Head of ETF Global Markets, BlackRock, dated November 27, 2018 (“BlackRock Letter”).

⁸ 15 U.S.C. 78s(b)(2)(B).

⁹ A “FLEX Option” is a customized options contract that is subject to the rules in Section 15, Flexible Exchange Options. See NYSE American Rule 900G(b)(1). A “FLEX Equity Option” is an option on a specified underlying equity security that is subject to the rules of Section 15. See NYSE American Rule 900G(b)(10).

¹⁰ See NYSE American Rule 903G(c)(3)(i). There is an exception to physical settlement for settlement of FLEX Binary Return Derivatives (“ByRDs”). See NYSE American Rules 900G(b)(17), 903G(c)(3)(ii), and 910ByRDs.

¹¹ The “Option Penny Pilot” is a pilot program by the options exchanges that permits certain option classes to be quoted in penny or nickel increments on a pilot basis. See NYSE American Rule 960NY, Commentary .02. See also Securities Exchange Act Release No. 55162 (January 24, 2007), 72 FR 4738, 4739 (February 1, 2007) (SR-Amex-2006-106) (“Option Penny Pilot Approval Order”). The Option Penny Pilot is currently set to expire on December 31, 2018. See NYSE American Rule 960NY, Commentary .02.

¹² See proposed NYSE American Rule 903G(c)(3)(ii). The Exchange proposes conforming changes to NYSE American Rule 903G(c)(3) to reflect that the proposed rule change would add a second exception to the general requirement for physical settlement for FLEX Equity Options. See proposed NYSE American Rule 903G(c)(3)(i) and (iii).

part of investors' portfolios, allowing investors to take advantage of many unique opportunities to hedge their portfolios and manage risk.¹³ The Exchange asserts that physical settlement possess certain risks with respect to volatility and movement of the underlying security at expiration that market participants may need to hedge against and cash settlement does not present these same risks.¹⁴

The Exchange states that it seeks to allay concerns about cash-settled equity options by proposing to adopt cash settlement as an alternative settlement method for 64 ETFs that are included in the Option Penny Pilot.¹⁵ The Exchange adds that generally index options are cash-settled and derive their value from a disseminated index price, and that similarly ETFs typically have their values linked to a disseminated index price.¹⁶ The Exchange states that the option classes included in the original pilot were chosen based on being one of the most actively-traded multiply-listed options classes and also states that the most recent expansion identified the most-active classes based on the "underlying security's 'national average daily volume over a six-month period.'"¹⁷

¹³ See Notice, supra note 4, at 51535-36.

¹⁴ See id. at 51536. The Exchange also states that market participants trade cash-settled FLEX ETF Options in the over-the-counter market and exchange trading would provide benefits to these market participants. See id.

¹⁵ See id.

¹⁶ See id.

¹⁷ See id. The Commission notes that the criteria for qualifying for the Option Penny Pilot is based on the national average daily volume over a six month period in the options class itself, not based on the volume of the underlying ETF. See Securities Exchange Act Release No. 60711 (September 23, 2009), 74 FR 49419 (September 28, 2009) (SR-NYSEArca-2009-44) ("Option Penny Pilot Expansion Order") and Securities Exchange Act Release No. 61106 (December 3, 2009), 74 FR 65193 (December 9, 2009) (NYSEAmex-2009-74) (Option Penny Pilot Expansion Notice").

The Exchange states that cash-settled FLEX ETF Options would be subject to the same position limits as non-cash-settled FLEX ETF Options (i.e., the position limits in NYSE American Rule 906G).¹⁸ The Exchange represents that it confirmed with the Options Clearing Corporation (“OCC”) that OCC can support the clearance and settlement of cash-settled FLEX ETF Options.¹⁹ The Exchange also states that it believes the Exchange and the Options Price Reporting Authority (“OPRA”) have the necessary systems capacity to handle the additional traffic associated with the listing of cash-settled FLEX ETF Options and that it believes that its members will not have a capacity issue as a result of the proposal.²⁰ The Exchange represents that it does not believe that the proposed rule change will cause fragmentation of liquidity.²¹ The Exchange further represents that it will monitor the trading volume associated with the options series listed as a result of this proposed rule change and the effect, if any, of these series on market fragmentation and on the capacity of the Exchange’s automated systems.²²

The Exchange represents that it will have an adequate surveillance program for cash-settled FLEX ETF Options and states that it intends to use the same surveillance procedures, including procedures concerning surveillance for manipulation, for cash-settled FLEX ETF

¹⁸ See Notice, supra note 4, at 51536. The Exchange adds that other existing regulatory safeguards, such as exercise limits and reporting requirements, would also continue to apply. See id. at 51537. The Commission notes that NYSE American Rule 906G provides generally that there are no position limits for FLEX Equity Options, but that positions in FLEX Options that expire on a third Friday-of-the-month expiration day (“Expiration Friday”) will be aggregated with positions in non-FLEX Options on the same underlying and subject to the position limits applicable to such options. See NYSE American Rule 906G(b).

¹⁹ See Notice, supra note 4, at 51536.

²⁰ See id.

²¹ See id.

²² See id.

Options that it uses for the Exchange's other options products.²³ The Exchange states that it believes manipulating the settlement price of cash-settled FLEX ETF Options would be difficult because of the size of the market for such ETFs.²⁴ According to the Exchange each cash-settled FLEX ETF Option is sufficiently active so as to alleviate concerns about the potential for manipulation.²⁵ The Exchange states that the vast liquidity of ETF options and the underlying equities markets and the high level of participation among market participants that enter quotes or orders in ETF options would, according to the Exchange, make it very difficult for a single participant to alter the prices of each security underlying an ETF without becoming exposed to regulatory scrutiny and that such attempt at manipulation would be cost-prohibitive.²⁶ Moreover, the Exchange states that it is a member of the Intermarket Surveillance Group ("ISG") and therefore would have access to surveillance and investigative information regarding trading in the underlying securities.²⁷

The Commission received one comment letter, which supports the proposed rule change.²⁸ The commenter states that it agrees with the Exchange that the proposal alleviates several potential challenges associated with physical settlement and presents advantages to the end investor. This commenter asserts that the proposal would lead to greater standardization of contract terms, mitigate counterparty risk, increase price discovery, and improve information dissemination, which would lead to greater transparency.²⁹

²³ See id.

²⁴ See id.

²⁵ See id. at 51536-37.

²⁶ See id. at 51537.

²⁷ See id.

²⁸ See BlackRock Letter, supra note 7.

²⁹ See id.

III. Proceedings to Determine Whether to Approve or Disapprove SR-NYSEAMER-2018-39 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Act to determine whether the proposal should be approved or disapproved.³⁰ Institution of such proceedings is appropriate at this time in view of the legal and policy issues raised by the proposed rule change, as discussed below. Institution of disapproval proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved.

Pursuant to Section 19(b)(2)(B) of the Act, the Commission is providing notice of the grounds for disapproval under consideration. The Commission is instituting proceedings to allow for additional analysis and input concerning the proposed rule change's consistency with the Act³¹ and, in particular, with Section 6(b)(5) of the Act, which requires, among other things, that the rules of a national securities exchange be 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.³²

As discussed above, the Exchange proposes to modify NYSE American Rule 903G(c)(3)(ii) to allow cash settlement for FLEX ETF Options. In its proposal, the Exchange acknowledges that concerns have been raised in the past regarding the susceptibility of cash-settled equity options to manipulation. The Exchange asserts that to address such concerns, it has proposed to limit cash settlement to options on a narrow set of ETFs that are the most actively

³⁰ 15 U.S.C. 78s(b)(2)(B).

³¹ 15 U.S.C. 78f(b)(5).

³² Id.

traded, as evidenced by the inclusion of options on those ETFs in the Option Penny Pilot.³³ The Commission notes that the goal of the Option Penny Pilot since its inception has been to analyze the impact of penny quoting on options spreads, transaction costs, payment for order flow, and quote message traffic.³⁴ As a result, the Option Penny Pilot eligibility criterion is based on the national average daily volume of the options classes rather than the volume in the underlying securities.

The Commission notes that critical to any assessment of the potential for manipulation when trading cash-settled options on ETFs is also an analysis of the liquidity and depth of the market for both the ETFs underlying the options and the component securities of the ETFs themselves. The Exchange has not, however, provided any specific data, analysis, and studies demonstrating that the ETFs underlying the options included in the Option Penny Pilot have the liquidity necessary to adequately address concerns on the risks of manipulation and potential for market disruption that may arise from cash settlement on such options.

As noted above, because options in the Option Penny Pilot are assessed every six months based on options trading volume, we believe the 64 ETFs underlying the options in the Option Penny Pilot that the Exchange identifies generally in its proposal were those eligible for the pilot as of the date the Exchange submitted its proposal to the Commission. This raises further questions, which are not addressed in the current proposal, as to how the Exchange will treat options on those ETFs that become ineligible for the Option Penny Pilot in the future, as well as how to analyze the potential for manipulation and market disruption from future ETFs

³³ See Notice, supra note 4, at 51536.

³⁴ See Option Penny Pilot Approval Order, supra note 11, at 4740. As noted in the 2009 Option Penny Pilot Expansion Order, for example, the pilot report provided information on the most active and least active options classes in the pilot and analyzed the impact the pilot had on those options in certain specified areas. See supra note 17, at 49420. See also Option Penny Pilot Expansion Notice, supra note 17, at 65194.

underlying options that are not yet, but later, included in the Option Penny Pilot and will therefore become eligible for cash settlement under the Exchange's proposal.

The Exchange also takes the position that cash settlement for options is not unique because other options exchanges trade cash-settled options.³⁵ Cash-settled options on equity securities such as ETFs that hold specific component securities, however, are unique and present distinct issues different from cash-settled index options that track an index. The Commission notes that allowing for cash settlement of FLEX ETF Options, as proposed, would permit cash settlement on a significantly broader set of equity options than that previously approved. Further, it is not clear from the Exchange's proposal how the expanded use of cash settlement for equity options may bear on the potential for manipulation or impact market quality since, as noted above, the proposal lacks any supporting data or analysis on these issues.

The Exchange proposes to apply the same position limits to cash-settled FLEX ETF Options as for other FLEX Equity Options. The Commission notes that the Exchange generally does not impose position limits for FLEX Equity Options unless the FLEX Equity Options' expiration coincides with an Expiration Friday.³⁶ This means that there would be no position limits, including on the days leading up to and surrounding Expiration Friday, for many of the cash-settled FLEX ETF Options under the proposal. The Commission is therefore concerned that the lack of position limits for non-Expiration Friday expiring cash-settled FLEX ETF Options could make them more susceptible to manipulation and could lead to market disruption.

Finally, the Commission notes that the proposal would allow for settlement in cash or by physical delivery on options that otherwise have the same terms. The Commission notes that

³⁵ See Notice, supra note 4, at 51536.

³⁶ See NYSE American Rule 906G(b).

allowing both physical delivery and cash settlement alternatives could increase market fragmentation and raise additional manipulation concerns.

The Commission notes that under the Commission’s Rules of Practice, the “burden to demonstrate that a proposed rule change is consistent with the Exchange Act and the rules and regulations issued thereunder ... is on the self-regulatory organization [‘SRO’] that proposed the rule change.”³⁷ The description of a proposed rule change, its purpose and operation, its effect, and a legal analysis of its consistency with applicable requirements must all be sufficiently detailed and specific to support an affirmative Commission finding,³⁸ and any failure of an SRO to provide this information may result in the Commission not having a sufficient basis to make an affirmative finding that a proposed rule change is consistent with the Exchange Act and the applicable rules and regulations.³⁹

For these reasons, the Commission believes it is appropriate to institute proceedings pursuant to Section 19(b)(2)(B) of the Act to determine whether the proposal should be approved or disapproved.

IV. Commission’s Solicitation of Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the issues identified above, as well as any other concerns they may have with the proposal. In particular, the Commission invites the written view of interested persons concerning whether the proposal is consistent with Section 6(b)(5) or any other provision of the Act, or the rules and regulations thereunder. Although there do not appear to be any issues relevant to approval or disapproval that would be facilitated by an oral

³⁷ Rule 700(b)(3), Commission Rules of Practice, 17 CFR 201.700(b)(3).

³⁸ See id.

³⁹ See id.

presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4, any request for an opportunity to make an oral presentation.⁴⁰

Interested persons are invited to submit written data, views, and arguments regarding whether the proposal should be approved or disapproved by [insert date 21 days from publication in the Federal Register]. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by [insert date 35 days from publication in the Federal Register]. The Commission asks that commenters address the sufficiency of the Exchange's statements in support of the proposal which are set forth in the Notice,⁴¹ in addition to any other comments they may wish to submit about the proposed rule change.

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 email 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

⁴⁰ Section 19(b)(2) of the Exchange Act, as amended by the Securities Act Amendments of 1975, Pub. L. 94-29 (June 4, 1975), grants the Commission flexibility to determine what type of proceeding—either oral or notice and opportunity for written comments—is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Act Amendments of 1975, Senate Comm. on Banking, Housing & Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 30 (1975).

⁴¹ See Notice, supra note 4.

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]. Rebuttal comments should be submitted by [insert date 35 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁴²

Brent J. Fields
Secretary

⁴² 17 CFR 200.30-3(a)(57).