Self-Regulatory Organizations; Cboe Exchange, Inc.; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, to Adopt Rule 6.10 to Introduce a Voluntary Multilateral Compression Service for SPX Options

July 8, 2021.

I. Introduction

On March 24, 2021, Cboe Exchange, Inc. (“Exchange” or “Cboe”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”) and Rule 19b–4 thereunder, a proposed rule change to adopt new Cboe Rule 6.10 to introduce a voluntary compression service for market makers. The proposed rule change was published for comment in the Federal Register on April 12, 2021. On May 25, 2021, the Commission designated a longer period within which to approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to disapprove the proposed rule change. On July 7, 2021, the Exchange filed Amendment No. 1 to the proposed rule change, which replaced and superseded the proposed rule change in its entirety. The Commission is publishing this notice to solicit comments on the Exchange’s

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4 See Securities Exchange Act Release No. 92011, 86 FR 29334 (June 1, 2021). The Commission designated July 11, 2021, as the date by which it should approve, disapprove, or institute proceedings to determine whether to disapprove the proposed rule change.
5 In Amendment No. 1, the Exchange: (1) narrowed the list of index options that could be compressed to include only SPX options and limited the compression service to closing positions only, (2) expanded eligibility from only market makers to all TPHs, (3) added detail to the participation requirements to ensure that the proposed compression service is limited to legitimate compression purposes, (4) added further detail regarding the proposed compression service, and (5) added additional justification for the proposed rule change.
proposal, as modified by Amendment No. 1, from interested persons and is approving the Exchange’s proposal, as modified by Amendment No. 1, on an accelerated basis.

II. Description of the Proposed Rule Change, as Modified by Amendment No. 1

The Exchange proposes to adopt new Cboe Rule 6.10 to provide Trading Permit Holders (“TPHs”) with an additional voluntary compression tool that they can use to reduce required capital attributable to their S&P 500 Index (“SPX”) options holdings. The Exchange’s proposal is designed to address the impact on liquidity providers of the limited amount of capital available from clearing broker-dealers that is a consequence of, among other things, the fact that a number of clearing TPHs are now subsidiaries of U.S. bank holding companies that must, as a result of this affiliation, comply with additional bank capital regulatory requirements. In particular, bank capital rules do not currently permit deductions for hedged securities or offsetting options positions to the same extent that the federal securities laws and self-regulatory organization rules do for securities. The impact of this dynamic most acutely impacts SPX options due to the popularity of SPX options and the significant number of open index options positions combined with their large notional value.

In its filing, the Exchange explains that it has observed that these bank capital rules have caused clearing broker-dealers to impose stricter position limits on their clearing members, which can impact the liquidity that TPHs, notably market makers who are frequently the counterparties to a significant portion of SPX option trades, might be able to supply. This impact would be most pronounced when markets are volatile, precisely at the time when the market would benefit from increased liquidity provision.

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6 Currently, the Exchange offers other methods by which TPHs can compress certain types of options holdings, including (1) Cboe Rule 5.6, which allows for compression orders in SPX options and (2) Cboe Rule 6.8, which allows TPHs to transfer positions off-exchange if the transfer does not result in a change of ownership and reduced the risk-weighted assets associated with those positions.

7 See Amendment No. 1, at 8-10.
The bank regulatory agencies have approved replacing the Current Exposure Method (“CEM”) with the Standardized Approach to Counterparty Credit Risk (“SA-CCR”) in the near future, and the Exchange believes SA-CCR will be “less punitive” to clearing broker-dealers because SA-CCR “will help correct many of CEM’s flaws by incorporating risk-sensitive principles, such as delta weighting options positions and more beneficial netting of derivative contracts that have economically meaningful relationships.”

Nevertheless, the Exchange believes that SA-CCR “will not eliminate [TPHs’] need for compression” as the ability to compress SPX positions can “enable them to provide more meaningful liquidity to the market, particularly during times of volatility when the market needs this liquidity most.” The Exchange further asserts that “this additional liquidity may result in tighter spreads and more execution opportunities, which benefits all investors.”

As described more fully in the Notice, as modified by Amendment No. 1, in order to be able to participate in the new multilateral compression service, a TPH must request access to the service and complete a standard test to demonstrate its capacity to participate. While the Exchange initially proposed that only registered market makers would be eligible to participate and a larger number of index options would be eligible for inclusion, the Exchange has modified its proposal to allow any TPH to request access and to limit the service to SPX options only, where the need for compression is most present.

The Exchange will offer multilateral compression periodically, initially twice per month, in order to allow TPHs to respond to intra-month reviews of regulatory capital for their positions by their clearing broker-dealers. To participate, a TPH must submit a “position list” after the close of trading on the specified day that details all of the open SPX positions it would like to

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8 See id. at 10.
9 See id. at 11.
10 See id.
11 See generally Amendment No. 1.
12 See Amendment No. 1, at 17.
close out and compress. The list must specify the amount of capital reduction associated with each closing position, the theoretical value of each position, the maximum cost the TPH is willing to accept to compress all of the positions (in the aggregate), the maximum cost per unit of capital reduction the TPH is willing to accept, and at least one risk constraint of the TPH’s choosing including a minimum and maximum value. TPHs have flexibility in choosing these values as specified in the proposed rule.\textsuperscript{13}

After the deadline for submission of the position lists, the Exchange runs an automated process to match offsetting positions in an anonymized manner. The process identifies the outcome that would result in the maximum aggregate capital reduction among all participating TPHs (picking at random from among equal outcomes). The Exchange determines the compression price for each option, which will be “as close as possible to the midpoint of the [national best bid and offer] at the close of the trading day or the daily marking time, subject to adjustment using generally accepted volatility and options pricing models in the event of wide markets, market volatility, or other unusual circumstances.”\textsuperscript{14}

The Exchange then notifies the TPH participants of each TPH’s individual compression proposal.\textsuperscript{15} Each TPH with at least one offsetting position must notify the Exchange whether it accepts its individual proposal.\textsuperscript{16} If all compression participants accept their individual

\textsuperscript{13} See, e.g., proposed Cboe Rule 6.10(b)(2) (concerning a theoretical value “calculated in a manner of the compression participant’s choosing”).

\textsuperscript{14} Proposed Cboe Rule 6.10(c)(2).

\textsuperscript{15} See id.

\textsuperscript{16} See proposed Cboe Rule 6.10(d).
proposals, then the Exchange effects the transactions at the specified prices off the exchange.\textsuperscript{17}

If one compression participant declines, then no compression transactions are effected.\textsuperscript{18}

III. Discussion and Commission Findings

After careful review of the proposal and the comments received, all of which supported the proposal and recommended that the Commission approve it, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange.\textsuperscript{19} In particular, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with Section 6(b)(5) of the Act,\textsuperscript{20} 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.

In support of its proposal, the Exchange states that compression transactions under Cboe Rule 6.10 will have a narrow scope and are intended and designed to achieve the limited purpose of capital reduction.\textsuperscript{21} The Exchange further explains that it understands that TPHs have no need for price discovery or price improvement for compression transactions, because the purpose of the transfer is to reduce capital requirements attributable to the TPHs’ positions and the price of

\textsuperscript{17} See id. In Amendment No. 1, the Exchange represented that it will disseminate compression transaction information to OPRA. The Exchange further states that it has completed system work to apply an indicator to such information and is working with OPRA so that OPRA is able to incorporate that indicator. The Exchange expects OPRA to complete its work in 2021, but notes that the indicator may not be available upon implementation of the compression service. See Amendment No. 1, at 27.

\textsuperscript{18} See id.

\textsuperscript{19} 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).

\textsuperscript{20} 15 U.S.C. 78f(b)(5).

\textsuperscript{21} See Amendment No. 1, at 37.
the compression transaction is a secondary concern. The Exchange further states that its proposal is needed because liquidity providers accumulate SPX positions to accommodate executions of customer orders, and do so at increasing levels during times of market volatility. While TPHs hold these positions prior to expiration, many may have little to no value and closure of these positions may have little impact on the risk exposure of the TPH’s portfolio. Yet, maintenance of these positions requires ongoing risk management and capital, which can impact the capital the TPHs have available to trade. The Exchange asserts that its proposal will limit the use of the compression service to legitimate compression purposes and provide an objective process to allow TPHs to manage capital and margin requirements so that they have sufficient capital available to provide to the markets, which will benefit all market participants.

The Commission believes that the Exchange’s proposal will provide a narrowly-tailored, objective, and not unfairly discriminatory mechanism for TPHs to efficiently compress open SPX positions for the purpose of reducing required capital. As the Commission has previously observed, the affiliation of clearing brokers with bank holding companies has introduced the need for liquidity providers and their clearing firms to more conservatively manage holdings to comply with applicable bank regulatory capital requirements. The ability to compress positions in an efficient, cost-effective manner can help liquidity providers and their clearing firms manage

22 See id.
23 See id., at 38.
24 See id.
25 See id.
26 See id., at 41. Two commenters supported the proposed rule change, asserting that the proposed compression service procedure would provide an additional risk management tool that can be used by Cboe market makers to efficiently manage the capital and margin requirements of their portfolios. See Letters to Vanessa Countryman, Secretary, Commission, from Joanna Mallers, Secretary, FIA Principal Traders Group, dated May 3, 2021, at 2; and Michael Golding, Head of Trading, Optiver US LLC and Aldo van Audenaerde, Head of Trading, AMS Derivatives B.V., dated April 22, 2021, at 1.
associated bank capital constraints. Tailored compression tools that are carefully designed to directly address the greatest need for compression, where portfolio holdings have a material impact on available capital, can have beneficial effects on the market and available liquidity especially during periods of volatile trading without impacting trading or conferring any inappropriate benefits on any market participant.

The proposal’s focus on closing positions in SPX options appropriately recognizes the role SPX options play as major component of the capital impact felt by clearing broker-dealers and the TPHs for whom they clear, which results from the large notional value and popularity of SPX options as a frequently traded product with large open interest. Compression trades are unlike arm’s length transactions as their sole purpose is to close open positions to compress SPX portfolio positions to reduce required capital charges. The Exchange’s proposal is a narrowly-tailored means of doing so and, as a result, should facilitate the ability of compression participants to provide liquidity and trade, especially during volatile periods. As such, the Exchange’s proposal removes impediments to and perfects the mechanism of a free and open market and a national market system, and, in general, protects investors and the public interest.

Further, the mechanics of the compression service are reasonably designed to provide an objective process by which TPHs can avail themselves of the ability to potentially compress their open SPX positions for capital reduction purposes. The proposed process does not prioritize any TPH but rather aims to find the greatest aggregate capital reduction among the SPX options submitted for consideration, and honors each TPH’s customized risk constraints in doing so. Ultimately, however, all TPHs selected for participation must approve of the compression transaction proposed by the Exchange and if any one TPH declines the proposed transaction then the compression transaction for all TPHs will not occur. If approved, transactions take place after the close of regular trading hours and the trades will be reported to OPRA with an indicator attached to note they are compression trades,28 thus providing public transparency of these

28 See supra note 17.
Accordingly, for the reasons discussed above, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with the Act, including Section 6(b)(5) of the Act\(^\text{29}\) and the rules and regulations thereunder applicable to a national securities exchange.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as modified by Amendment No. 1, 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-CBOE-2021-020 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-CBOE-2021-020. 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 the 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-CBOE-2021-020, and should be submitted on or before [insert date 21 days from publication in the Federal Register].

V. Accelerated Approval of Proposed Rule Change, as Modified by Amendment No. 1

The Commission finds good cause to approve the proposed rule change, as modified by Amendment No. 1, prior to the 30th day after the date of publication of notice of the filing of Amendment No. 1 in the Federal Register. Amendment No. 1 narrowed the scope of parts of the proposed rule change and also provided additional rationale and support for the proposed rule change. Specifically, in Amendment No. 1, the Exchange: (1) narrowed the list of index options that could be compressed to include only SPX options and limited the compression service to closing positions only, (2) expanded eligibility from only market makers to all TPHs, (3) added detail to the participation requirements to ensure that the proposed compression service is limited to legitimate compression purposes, (4) added further detail regarding the proposed compression service, and (5) added additional justification for the proposed rule change.

The changes to the proposal and additional information provided in Amendment No. 1 focus the proposal on SPX and closing-only positions, expand eligibility to the compression service, and add necessary detail to the rule text to more fully and clearly reflect the applicable requirements and describe how the compression service will operate. Collectively, these changes, supported by the additional and clarified rationale, better calibrate the proposal to the greatest need for compression and remove potential ambiguity about how the service will work without introducing material new concepts over the original proposal. The changes in
Amendment No. 1 assist the Commission in evaluating the Exchange’s proposal and in determining that it is consistent with the Act. Accordingly, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act,\(^{30}\) to approve the proposed rule change, as modified by Amendment No. 1, on an accelerated basis.

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,\(^{31}\) that the proposed rule change (SR-CBOE-2021-020), as modified by Amendment No. 1, be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.\(^{32}\)

J. Matthew DeLesDernier,
Assistant Secretary.

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\(^{31}\) Id.
\(^{32}\) 17 CFR 200.30-3(a)(12).