

Exchange proposes to amend this rule to codify two instances when the bid-ask differential for options trading with a bid price of less than \$2 may be wider than the \$0.25 interval expressly required for such options by CBOE Rule 8.7(b)(iv). Specifically, proposed CBOE Rule 8.7(b)(iv)(A) authorizes the appropriate MPC, with respect to options trading with a bid price less than \$2, to establish bid-ask differentials that are no more than \$0.50 wide ("double-width") when the primary market for the underlying security: (a) Reports a trade that occurs outside of its disseminated quote (including any Liquidity Quote); or (b) disseminates an inverted quote (together, the "triggering events"). The proposed quote width relief will apply to options on stocks and options on exchange-traded funds ("ETFs").⁸

The proposed quote width relief will apply only to options that trade with a bid price of less than \$2.⁹ Thus, options trading at a price of \$2 (bid) or higher will not be eligible for the proposed quote width relief. The CBOE notes that options trading at less than \$2 are subject to a \$0.25 bid-ask differential, which generally means that market makers have only \$0.125 of pricing latitude on either side of the theoretical value to widen their quotes to take into account any pricing discrepancy in the underlying security. As described more fully below, the CBOE believes that the grant of double-width relief for low-priced options will provide market makers with more pricing flexibility with which to protect themselves.

Under the proposal, CBOE market makers will not be permitted to widen their quotes when the NYSE prints a trade at or within its Liquidity Quote. Because the NYSE disseminates Liquidity Quotes, which are quotes of substantial size outside of the regular disseminated quote, the CBOE notes that CBOE market makers should not be surprised if the NYSE prints a trade outside of its regular quote but at or within its Liquidity Quote. For this

but does not exceed \$5; no more than \$0.50 where the bid is more than \$5 but does not exceed \$10; no more than \$0.80 where the bid is more than \$10 but does not exceed \$20; and no more than \$1.00 where the bid is more than \$20. The bid/ask differentials do not apply to in-the-money series where the underlying securities market is wider than the differentials set forth in CBOE Rule 8.7(b)(iv). For those series, the bid/ask differential may be as wide as the quotation on the primary market of the underlying security.

⁸ Upon Commission approval of the proposal, the CBOE, prior to the effective date of the rule, will disseminate to members a Regulatory Circular that identifies the specific ETF that will serve as the underlying security for each option class. See Amendment No. 3, *supra* note 5.

⁹ See Amendment No. 3, *supra* note 5.

reason, the CBOE does not propose to allow the MPC to authorize CBOE market makers to widen their quotes when the NYSE prints a trade at or within its Liquidity Quote. However, if the NYSE prints a trade outside of the Liquidity Quote, a CBOE market maker would be able to widen its quotes. The following example illustrates the operation of the proposal with respect to Liquidity Quotes:

- NYSE disseminated quote: \$23.10–\$23.20, 300 × 1000
- NYSE Liquidity Quote: \$22.95–\$23.35, 15,000 × 15,000

With the above quotes, if the NYSE reports a trade between \$22.95 and \$23.35, CBOE market makers would not be permitted to quote double-wide. If the NYSE reports a trade below \$22.95 or above \$23.35 without changing its disseminated quote, CBOE market makers would be permitted to quote double-wide.

The CBOE intends to automate its systems so that the CBOE's autoquote systems automatically will widen the quote to double the bid-ask differential upon the occurrence of either of the two triggering events.¹⁰ The quotes will remain double-width until the triggering event ceases, at which time CBOE systems automatically will return the quote to the normal bid-ask differential. Accordingly, if the primary market's quotes invert and the CBOE quotes double-wide, the CBOE's quotes must return to normal width when the underlying market's quotes no longer are inverted. Similarly, if the primary market prints a trade outside of its disseminated quote, the CBOE may quote double-wide until the print is no longer outside of the disseminated quotes (*i.e.*, until the quotes move to encompass the previous print or the next print is inside of the disseminated quotes).¹¹

The CBOE notes that the automation of this process ensures that double-width relief will take effect only when permissible and, more importantly, will last only as long as the condition that necessitated it occurs. Thus, there will be no sustained dissemination of stale double-wide quotes when one of the triggering events is not present.¹² In addition, the CBOE states that a market maker will be able to utilize the double-width relief only if the market maker has an automated quotation system that returns the market maker's quotes to normal width upon the termination of the triggering event.¹³ Double-width

relief will not be available to market makers who must rely on manual input to restore quote values to normal width.

The CBOE notes that the grant of double-width relief will not result in the automatic execution of customer orders at artificially wide prices.¹⁴ According to the CBOE, neither RAES nor the CBOE Hybrid System will automatically execute incoming orders at prices inferior to the NBBO. Instead, orders received while the CBOE is not the NBBO will route to PAR, where the DPM can expose the order to the crowd or send a linkage order to an away market. Accordingly, the CBOE notes that orders received while the CBOE's quotes are double-wide would receive a measure of price protection.

In addition, the CBOE represents that the purpose of the proposal is not to create a heightened profit opportunity by allowing CBOE market makers to execute trades at widened quotes and, hence, increased profits.¹⁵ Instead, the CBOE believes that the proposal represents a narrowly-tailored protective measure designed to enable CBOE market makers to widen their quotes when a situation occurs in the underlying market that prevents accurate pricing. Under the proposal, market makers will have the ability, if they choose, to widen their quotes to limit the losses that may occur when the underlying market disseminates faulty or delayed information.

Necessity for the Relief Requested

According to the CBOE, the main component of equity option pricing is the value of the underlying security. The CBOE states that accurate option pricing is impossible if the value of the underlying security is unreliable or indiscernible. The following examples provided by the CBOE highlight the difficulties and risks in pricing options when the quote for the underlying security is inverted and/or when the underlying market prints a trade outside of its disseminated quote.

a. Underlying Market Disseminates an Inverted Quote

Assume that the quote for stock ABCD is \$21.06–\$21.16 and that, based on those prices, the quote for the July 20 call option is \$1.15–\$1.25. Now assume that the stock quote changes to \$21.12–\$21.02, creating an inversion. Under these circumstances, it is not clear which price, the bid or the offer, is correct, or whether both prices are incorrect. If the bid is correct, the quote for the underlying stock might be

¹⁰ See Amendment No. 1, *supra* note 3.

¹¹ See Amendment No. 3, *supra* note 5.

¹² See Amendment No. 1, *supra* note 3.

¹³ See Amendment No. 3, *supra* note 5.

¹⁴ See Amendment No. 2, *supra* note 4.

¹⁵ See Amendment No. 2, *supra* note 4.