Many Voices Create Harmony in the Options World:

A Summary of the Obvious Error Filing

By Jeromee Johnson, Head of BATS Options

The proposed plan to implement harmonized obvious error rules across the options exchanges, which was filed with the Securities and Exchange Commission (SEC) on December 4, 2014, is a big step forward for the industry. It has been many months in the making, but there is a bright light at the end of the tunnel now.

As the options marketplace has grown the past few years to now include 12 options exchanges, the need was evident for harmonized obvious error rules — rules that outline the process related to the adjustment and nullification of erroneous options transactions — across the options exchanges. When a market participant experiences an error, the clock is ticking for them to submit their notification to the exchange. Today's process of sorting through the multiple and varied obvious error rules of the different options exchanges can be a challenging and frustrating process. Competing obvious error rules create potential conflicts, disincentives and investor confusion — "How and why would the same trade stand on one exchange yet be adjusted or busted on another exchange?" It was clear that a transparent, harmonized set of trade-break rules was necessary in today's modern marketplace.

The proposed filing outlines the objective: "the proposed changes seek to achieve consistent results for participants across U.S. options exchanges while maintaining a fair and orderly market, protecting investors and protecting the public interest."

Coordination and Compromise

In the spring of 2013, the SIFMA Options Committee started to consider what changes needed to be made to help simplify and harmonize the options obvious error rules across the exchanges. Later that year the SEC summoned the exchanges to Washington to discuss key elements of critical market infrastructure that needed to be addressed and to put together a plan that harmonized rules related to the trade-break process, particularly in the options market. Following this directive, BATS raised its hand to help lead the effort in drafting the new model rule, working alongside the other exchanges to craft a model that everyone could use.

The first step in the process was outlining the scope of the project and determining what would be included and what would not be included. Collectively, the exchanges agreed upon key areas of harmonization we believed were critical and got to work on drafting the model rule.

Within the Existing Framework

Many compromises were made along the way by all of the options markets in order to get all 12 exchanges to agree to a harmonized rule for the greater good of the industry. Some of the key differences that were identified and addressed in the proposed rule include:

Consistent Adjust/Bust Treatment

The proposed rule modifies a number of the areas related to when and how trades are adjusted or busted. First, all exchanges will now have the ability to accept a mutual adjustment request. This provision will be subject to the operational and system constraints of the exchange to process the request as well as any applicable regulatory restrictions. Some exchanges will have an end-of-day cutoff; others will process up to just before the opening the following day. Second, when determining whether an obvious or catastrophic error has occurred, the price differential tables have been refined, giving greater protection to trading firms, and will be consistent across all exchanges. Third, across the exchanges there will be a consistent bust treatment for Priority Customers with an important exception — when a member of the exchange has more than 200 Customer transactions under review concurrently that resulted from orders sent over a time period of 2 minutes or less, only Customer-to-Customer transactions will be busted; other transactions will be adjusted.

Filing Times

The filing time deadlines for filing obvious error notifications will now be consistent across all exchanges. There will be a 15-minute window for non-customer orders, 30 minutes for customer orders, and an additional 15 minutes for linkage trades (trades routed by an exchange to another exchange). The filing process dictates that notifications must be filed according to the mechanism prescribed by the exchange.

Wide Quotes and the Determination of Theoretical Price

The proposed harmonized filing includes an important change to the treatment of wide quotes, in particular when the quotes are stable. When the market is wide, and there has not been a tighter market for at least 10 seconds (in other words, the market is well-established and stable at that wider price), theoretical price is determined the same way as when the exchange determines that it has a valid NBBO — the last NBB with respect to erroneous sell transactions, and the last NBO with respect to erroneous buy transactions. The "no bid" provision, which allows for trades to be busted if a series and the strike closest to it (up for puts and down for calls) are both no bid, has been eliminated.

Provisions to Be Universally Adopted

Historically, some exchanges had rules to address a specific circumstance in a number of areas, but these provisions were not, universally applicable across all of the exchanges. For example, under the proposed rule, all exchanges will now have obvious/catastrophic error rules that cover stop and stop limit orders, and erroneous quotes and prints in underlying securities.

New Concepts for Evolving Markets

Beyond addressing many of the areas where the exchanges had discrepancies between their current rules, the exchanges worked together to introduce new concepts. We believe these additions to the obvious and catastrophic error policies will give the exchanges better tools to address the errors that occur in their markets, especially when the errors are large or wide-spread.

Size Adjustment Modifier

The Size Adjustment Modifier attempts to account for the additional risk that the parties to a trade undertake when the transactions they execute are larger in size. The exchanges have introduced this new concept with a two-fold purpose: to increase the incentive around avoiding more impactful obvious errors and to lessen the impact to the contra-party to adjusted trades.

Significant Market Events

In order to improve consistency for market participants, in particular in the case of wide-spread market events, and in light of the interconnected nature of the options exchanges, the proposal introduces a framework that lays out criteria for Significant Market Events. One of the primary benefits of the Significant Market Event provision is that it allows for coordination and information sharing between the exchanges.

The Path Forward

As a whole, the industry has been supportive and in favor of this harmonization plan and we will continue to work with the SEC to get the proposed rule finalized and implemented across all the exchanges. Once approved by the SEC, all options exchanges will have the exact same language for obvious error rules, and we will have taken a big step forward in enhancing confidence and consistency across the options industry.

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