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**CIRCULAR 117-15**  
September 23, 2015

## **REQUEST FOR COMMENTS**

### **PENNY OPTIONS TRADING - END OF PILOT PROJECT AND IMPLEMENTATION OF A PERMANENT PROGRAM**

#### **AMENDMENTS TO ARTICLE 6624 OF THE RULES OF THE BOURSE**

The Rules and Policies Committee of Bourse de Montréal Inc. (the “**Bourse**”) has approved amendments to article 6624 of Rule Six of the Bourse in order to specify the minimum price increments for equity and ETF options. These amendments are part of the implementation of the permanent penny options trading program, given the pilot project will expire on February 26, 2016 as contemplated under Decision No. 2015-SMV-0007 rendered by the Autorité des marchés financiers (the “**Autorité**”).

Comments on the proposed amendments must be submitted within thirty (30) days following the date of publication of this notice, at the latest on October 23, 2015. Please submit your comments to:

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A copy of these comments shall also be forwarded to the *Autorité* to:

M<sup>e</sup> Anne-Marie Beaudoin  
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Please note that comments received by one of these recipients will be transferred to the other recipient and that the Bourse may publish a summary of such comments as part of the self-certification process concerning this file.

### **Appendices**

For your information, you will find in the appendices an analysis of the proposed amendments as well as the amendments proposed to article 6624 of Rule Six of the Bourse. The implementation date of the proposed amendments will be determined by the Bourse, in accordance with the self-certification process as determined by the *Derivatives Act* (R.S.Q., chapter I-14.01).

### **Process for Changes to the Rules**

The Bourse is authorized to carry on business as an exchange and is recognized as a self-regulatory organization (SRO) by the Autorité. The Board of Directors of the Bourse has delegated to the Rules and Policies Committee of the Bourse its powers to approve and amend the Rules and Procedures. The Rules of the Bourse are submitted to the Autorité in accordance to the self-certification process as determined by the *Derivatives Act* (R.S.Q., chapter I-14.01).



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AND IMPLEMENTATION OF PERMANENT PROGRAM**

**AMENDMENTS TO ARTICLE 6624 OF THE RULES OF THE BOURSE**

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## I. SUMMARY

On February 25, 2015, the *Autorité des marchés financiers* (the “AMF”) rendered decision No. 2015-SMV-0007 providing for the extension, until February 26, 2016, of the testing period for the authorization of a minimum price increment of \$0.01 on equity, ETF and index option contracts (the “Pilot Project”) traded on the Bourse de Montréal Inc. (the “Bourse”). The Bourse wishes to replace the Pilot Project with a permanent penny trading program, the selection criteria of which are appended to this document. The Bourse proposes to amend article 6624 of its Rules in order to specify the minimum price increments for equity and ETF options.

## II. ANALYSIS

### a. Background

On July 27, 2007, the Bourse launched a Pilot Project on 10 option classes.<sup>1</sup> This project was initially governed by the AMF decision No. 2007-OAR-0018 which was replaced by other decisions rendered by the AMF, up to decision No. 2015-SMV-0007 mentioned above.<sup>2</sup> On July 21, 2008, the Bourse added 10 other option classes to the initial control group.<sup>3</sup> In 2010, the Bourse extended the Pilot Project to 60 new option classes, which were added in four different phases, on January 25, April 12, July 12 and October 4.<sup>4</sup>

Therefore, the number of option classes in the Pilot Project eventually grew to 80 classes.

Pursuant to decision No. 2015-SMV-0007, only option contracts trading at less than \$3 are eligible to the minimum price increment of \$0.01 and the option classes allowed to trade with a minimum price increment of \$0.01 are those 80 classes included in the Pilot Project. Lastly, regardless of the price at which they trade, the following ETF option classes trade with a minimum price increment of \$0.01: iShares S&P/TSX Capped Energy Index ETF (XEG), iShares S&P/TSX Capped Financials Index ETF (XFN), iShares S&P/TSX Global Gold Index ETF (XGD) and iShares S&P/TSX 60 Index ETF (XIU).

As mentioned above, the Bourse proposes to end the Pilot Project and replace it with a permanent Penny Trading Program.

Four impact analyses of the Pilot Project were carried out in 2007, 2008, 2009 and 2011 and presented to the AMF. These analyses included information on bid/ask spreads, number of orders, number of trades, market volume and depth, as well as the capacity of the Bourse’s system.

These four studies concluded that penny trading did not seem to play a dominant role in the Bourse’s market operations and therefore did not have an impact on liquidity measures comparable to the ones observed in the United States.

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<sup>1</sup> Circular No. 103-2007.

<sup>2</sup> Decision Nos. 2008-OAR-0005, 2008-OAR-0023, 2009-OAR-0007, 2009-OAR-0024, 2011-SMV-0012, 2012-SMV-0013, 2013-SMV-0019, 2014-SMV-0020 and 2015-SMV-0007.

<sup>3</sup> Circular No. 112-2008. AMF decision No. 2008-OAR-0023.

<sup>4</sup> Circular Nos. 007-2010; 030-2010; 084-2010; 118-2010. AMF decision No. 2009-OAR-0024.

The results of those 4 studies do show a general tightening of spreads, but nothing close to the tightening of spreads observed in the United States during the same period. Furthermore, while market depth has significantly deteriorated in the United States, penny increments as part of the Pilot Project in Canada has had an effect of reducing the quantities posted on the bid and ask, but less significantly than in the United States. Finally, the increase of the number of updates per second observed on the option classes trading in penny increments on the Bourse were a lot lower than the number seen in the United States.

These less compelling results are probably due to many exogenous factors like the very high volatility of the markets at the beginning of the Pilot Project, the fact that there were wider spreads posted on the markets of the Bourse than those in the United States before the beginning of the Pilot Project as well as the transformation that the Canadian options market was undergoing at the time as a result of a change in the market model.

The Bourse has recently developed a tool that allows it to measure the quality of the options market by calculating average spreads and sizes. The table below presents a comparison of the option classes quoted in penny increments against those that are not. The results show that the classes that are included in the Pilot Project have a tighter spread than those that are not. This is due not only to penny increment trading, but also to the fact that the included classes are those that are the most traded.

**Market Quality on Penny & Non-Penny Option Classes (07/15)**

Expirations	Included in the Pilot Project		Excluded of the Pilot Project	
	Average Size	Average Spread	Average Size	Average Spread
EQ				
Front	44.95	0.14 \$	26.92	0.23 \$
Quarterly	44.41	0.30 \$	29.47	0.34 \$
ETF				
Front	139.93	0.07 \$	21.84	0.22 \$
Quarterly	134.77	0.16 \$	17.16	0.32 \$

One example that demonstrates the impact of the penny trading is that of the GWO class which was added to the Pilot Project on July 21, 2014. The Bourse’s tool allows to compare the bid/ask spread and the number of contracts for a period of 90 days before and after the introduction of this class in the program.

The results show that there was an improvement of the average bid/ask spread for the front months, but a decrease of the average posted bid/ask sizes. This is in line with the conclusions of all the studies done on penny trading programs in Canada and the United States.

**90 Days Before GWO was Added to the Penny Pilot Program**

**Symbole: GWO**

	Average Bid Size	Average Ask Size	Average Spread
<b>Call</b>			
Front			
ITM	89.29	53.15	0.12 \$
ATM	94.44	65.70	0.10 \$
OTM	97.67	68.27	0.10 \$
<b>Put</b>			
Front			
ITM	87.19	50.34	0.14 \$
ATM	84.50	63.30	0.10 \$
OTM	79.21	64.78	0.09 \$

**90 days After GWO was Added to the Penny Pilot Program**

**Symbole: GWO**

	Average Bid Size	Average Ask Size	Average Spread
<b>Call</b>			
Front			
ITM	37.96	31.42	0.11 \$
ATM	52.09	38.28	0.08 \$
OTM	65.94	37.43	0.08 \$
<b>Put</b>			
Front			
ITM	44.44	27.82	0.12 \$
ATM	54.08	43.55	0.08 \$
OTM	58.69	35.96	0.07 \$

In conclusion, after eight years, the penny trading Pilot Project has become an integral part of the Canadian options market model. The Bourse considers that while the impacts measured in the first years are not as significant as those in the United States, the Canadian options market has evolved a lot since and that penny trading on the most active classes improves the bid/ask spread and therefore reduces the entry and exit costs.

**b. Comparative Analysis**

A penny pilot project was introduced in the United States in January 2007 with 13 option classes. The project was then expanded to include 363 classes.<sup>5</sup>

<sup>5</sup> <http://www.sec.gov/news/press/2007/2007-10.htm>.

The US program specifies a price increment of one cent for options trading at less than \$3.00 and a price increment of five cents for options trading at \$3.00 or more, except for QQQ (Powershares QQQ Trust), SPY (SPDR S&P 500 ETF Trust) and IWM (iShares Russel 2000 ETF), which trade in one-cent increments for all prices.<sup>6</sup>

The goal of this initiative was to show that tighter spreads would benefit retail clients and reduce payment for order flow.

There has been much discussion over the years in the United States about making the pilot project permanent. The US exchanges continue to work together to reach a consensus on a final common project.

The general consensus in the United States is that penny price increments have improved market quality in general and that it benefitted retail clients. The penny trading program will therefore most likely be made permanent.

Recently, the US exchanges asked the Securities and Exchange Commission (SEC) to extend the penny pilot project until June 30, 2016, or a closer date if the pilot is approved earlier to become permanent. This extension will allow them to determine how the project should be uniformly structured in its permanent form.<sup>7</sup>

The Bourse's proposal to make its Pilot Project permanent is consistent with the recommendations expressed by SIFMA in letters sent to SEC and NASDAQ OMX Group in August 2013 and January 2014 respectively.<sup>8</sup>

### **c. Proposed Amendments**

The Bourse proposes amending articles 6624 a) and 6624 b) of its Rules, in order to specify the minimum price increment for equity and ETF option classes included in the permanent Penny Trading Program versus those that are not included in the program.

In addition, to remain consistent with other articles of its Rules and the specifications of its products, the Bourse proposes making the following amendments to article 6624: (1) replacing the term "minimum quotation spread" with "minimum price increment"; and (2) replacing, in article 6624 b), the term "index participation unit" with "exchange-traded fund".

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<sup>6</sup> <http://www.ise.com/options/regulatory-and-fees/options-penny-pilot/>.

<sup>7</sup> <http://www.sec.gov/rules/sro/cboe/2015/34-75287.pdf>

<sup>8</sup> Securities Industry and Financial Markets Association (SIFMA), letter from Ellen Greene, Vice President, SIFMA to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated August 5, 2013, <http://www.sifma.org/comment-letters/2013/sifma-submits-comments-to-the-sec-on-extending-the-nyse-arca-penny-trading-program-and-making-a-permanent-penny-trading-program/>; SIFMA, letter from Ellen Greene, Vice-President, SIFMA to Thomas Wittman, Senior Vice President, NASDAQ OMX Group, dated January 29, 2014, <http://www.sifma.org/comment-letters/2014/sifma-submits-comments-to-all-us-options-exchanges-in-response-to-proposed-permanent-penny-program-for-the-us-options-exchanges/>.

As a result, the minimum price increment for options included in the permanent Penny Trading Program will be as follows:

- 1) All equity option series priced below \$3.00 will be quoted in increments of \$0.01;
- 2) Equity option series priced at \$3.00 or more will be quoted in increments of \$0.05; and
- 3) All exchange-traded fund (ETF) options will be quoted in increments of \$0.01, regardless of price level.

As for equity and ETF options not included in the permanent Penny Trading Program, their minimum price increment will be as follows:

- 1) Option series priced below \$0.10 will be quoted in increments of \$0.01; and
- 2) Option series priced at \$0.10 or more will be quoted in increments of \$0.05.

While decision 2015-SMV-0007 also covers index option classes, the Bourse does not propose to specify in article 6624 c) the minimum price increment for these option classes, since no index option is included in the Pilot Project and the Bourse does not intend, for the time being, to include these option classes in the Program.

The Bourse has established a series of criteria that will be used for the selection of equity and ETF option classes to be included in the permanent Penny Trading Program. These selection criteria will be published on the Bourse's website once the permanent Penny Trading Program takes effect.<sup>9</sup>

### **III. AMENDMENT PROCESS**

The amendment process is motivated by the willingness to end the Pilot Project for the purpose of replacing it with a permanent Penny Trading Program.

### **IV. IMPACT ON TECHNOLOGICAL SYSTEMS**

The Bourse does not anticipate any impact on its technological systems or those of its approved participants following implementation of the proposed amendments.

### **V. OBJECTIVES OF PROPOSED AMENDMENTS**

The objectives of the amendments is to specify, in article 6624 of its Rules, the minimum price increments for equity and ETF option classes depending on their inclusion or exclusion of the Penny Trading Program. The objective is also to replace the Pilot Project with a permanent Penny Trading Program.

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<sup>9</sup> The selection criteria are attached to this document, for information purposes.



## **VI. PUBLIC INTEREST**

The proposed amendments will clarify the wording of article 6624 and thereby prevent any confusion about the minimum price increments for equity and ETF option classes included in the current Pilot Project or the permanent project that will replace it.

## **VII. MARKET IMPACT**

The amendment process is initiated by the Bourse in order to make permanent the Pilot Project which has been active for more than eight years. The market reality is that the Pilot Project has been readily adopted by all participants and integrated into the structure of the Bourse's options market.

Over the past eight years, the Bourse has not received any complaints about the Pilot Project and foresees no negative impact by making it permanent.

## **VIII. PROCESS**

The proposed amendments will be submitted to the Bourse's Rules and Policies Committee for approval. They will also be submitted to the *Autorité des marchés financiers* in accordance with the self-certification process and to the Ontario Securities Commission for information purposes.

## **IX. ATTACHED DOCUMENTS**

- Proposed modifications of Article 6624 of the Rules;
- Selection criteria for the permanent Penny Trading Program (provided for information purposes).