

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-68070; File No. SR-C2-2012-024)

October 18, 2012

Self-Regulatory Organizations; C2 Options Exchange, Incorporated; Order Approving a Proposed Rule Change to Adopt a Designated Primary Market-Maker Program

I. Introduction

On August 21, 2012, the C2 Options Exchange, Incorporated (the “Exchange” or “C2”) filed with the Securities and Exchange Commission (the “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),¹ and Rule 19b-4 thereunder,² a proposed rule change to adopt a Designated Primary Market-Maker (“DPM”) program. The proposed rule change was published in the Federal Register on September 7, 2012.³ The Commission received no comment letters on the proposal. This order approves the proposed rule change.

II. Description of the Proposed Rule Change

As set forth in the Notice, C2 has proposed to adopt a DPM program. The associated proposed rules are based on the rules governing the DPM program on the Chicago Board Options Exchange, Incorporated (“CBOE”), excluding certain provisions that are inapplicable to C2 (such as provisions related to floor trading and CBOE-specific provisions) and other provisions that the Exchange believes are outdated.⁴

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 67772 (August 31, 2012), 77 FR 55257 (September 7, 2012) (the “Notice”).

⁴ See CBOE Rules 6.45A(a)(ii)(2) and (iii), 6.45B(a)(i)(2) and (iii), 8.80, 8.83 – 8.91, 8.95, and 17.50(g)(14).

The proposed rule change defines a DPM as a Participant⁵ organization that is approved by the Exchange to function in allocated securities as a Market-Maker and is subject to obligations under proposed Rule 8.17. Proposed Rule 8.14 sets forth the criteria that the Exchange will consider when reviewing a Participant organization's application to become a DPM. Each approved DPM will retain its status to act as a DPM for one year. After each one-year term, a DPM may file an application with the Exchange to renew its approval to act as a DPM. In addition, the Exchange may take action to suspend or limit a DPM's status, consistent with Rule 8.20 (concerning termination, conditioning, or limiting approval to act as a DPM).⁶

Proposed Rule 8.15 sets forth the manner in which the Exchange will allocate securities to DPMs. Specifically, the Exchange will determine for each security traded on the Exchange whether the security should be allocated to a DPM and, if so, to which DPM. The proposed rule also describes the criteria that the Exchange may consider in making allocation determinations.

Proposed Rule 8.15 further provides that the Exchange may remove an allocation from a DPM and reallocate the security during a DPM's term if the DPM fails to adhere to any market

⁵ A "Participant" is an Exchange-recognized holder of a Trading Permit ("Trading Permit Holder" or "TPH"). A Trading Permit is an Exchange-issued permit that confers the ability to transact on the Exchange. See Rule 1.1.

⁶ CBOE's DPM rules differ from proposed Rule 8.14 in several ways. CBOE Rule 8.83 provides that a DPM's term is unlimited (until the Exchange relieves or terminates the DPM of its approval to act as a DPM), and accordingly, unlike the proposed rule, lacks a provision allowing DPMs to renew their appointments after each one year term (cf. CBOE Rule 8.83(e)). Further, CBOE Rule 8.83 contemplates the resignation of a DPM, while the proposed rule does not because the Exchange believes resignation would be unnecessary given the one-year DPM term. The DPM can simply choose not to renew its application at the end of the term or ask C2 to relieve it of its approval (cf. CBOE Rule 8.83(f)). CBOE Rule 8.89 also permits a DPM to sell, transfer, or assign its appointment, which is prohibited without the prior written approval of the Exchange by proposed Rule 8.14(g). Finally, CBOE requires an annual review of DPM operations and performance, but because C2 only permits DPMs to have a one-year term, the Exchange believes an annual review is unnecessary, though in proposed Rule 8.14(e), it may conduct an evaluation of the extent to which the DPM has satisfied its obligations under Rule 8.17 in determining whether to renew the DPM's renewal application (cf. CBOE Rule 8.88(a)).

performance commitments made by the DPM in connection with receiving the allocation or the Exchange concludes that doing so is in the best interests of the Exchange based on operational factors or efficiency. The proposed rule also describes the procedures the Exchange must follow prior to taking any action to remove an allocation.

Proposed Rule 8.16 grants the Exchange the authority to establish: (1) restrictions applicable to all DPMs on the concentration of securities allocable to a single DPM and to affiliated DPMs, and (2) minimum eligibility standards applicable to all DPMs, which must be satisfied in order for a DPM to receive allocations of securities, including but not limited to standards relating to adequacy of capital and operational capacity.⁷

Proposed Rule 8.17 describes the obligations of a DPM, including the general obligation that a DPM must fulfill all of the obligations of a Market-Maker under Exchange Rules. In addition, the rule sets forth additional requirements applicable to DPMs, such as heightened quoting obligations and a duty to make competitive markets on the Exchange. In particular, DPMs will be subject to a requirement to provide a continuous quote throughout each trading day in 99% of their non-adjusted series (or 100% minus one put-call pair of each assigned class). Proposed Rule 8.18 sets forth the specific financial requirements for DPMs.

Proposed Rule 8.19 grants a trade participation right to DPMs, and gives the Exchange authority to establish a participation entitlement formula that is applicable to all DPMs.⁸ The proposed rule provides that: (1) a DPM will be entitled to a participation entitlement only if

⁷ The Commission notes that the exercise of the Exchange's authority under this provision would be subject to the rule filing requirements of Section 19 of the Act and, if so required, would have to be filed with the Commission before such changes can become effective. See 15 U.S.C. 78s.

⁸ The Commission notes that any changes to the participation entitlement formula would be subject to the rule filing requirements of Section 19 of the Act and, if so required, would have to be filed with the Commission before such changes can become effective. See 15 U.S.C. 78s.

quoting at the best bid or offer disseminated on the Exchange (“BBO”); (2) a DPM may not be allocated a total quantity greater than the quantity that the DPM is quoting at the BBO; and (3) the participation entitlement is based on the number of contracts remaining after all public customer orders in the Book at the BBO have been satisfied. The proposed rule also provides that the collective DPM participation entitlement shall be: 50% when there is one Market-Maker also quoting at the BBO and 40% when there are two or more Market-Makers also quoting at the BBO.⁹ If only the DPM is quoting at the BBO (with no Market-Makers quoting at the BBO), the participation entitlement will not be applicable and the allocation procedures under Rule 6.12 (Order Execution and Priority) will apply.

The Exchange proposed modifications to Rule 6.12 to accommodate the participation entitlement for DPMs. The proposed rule change provides that both PMMs and DPMs may be granted participation rights up to the applicable participation right percentage designated in Rule 8.13 and proposed Rule 8.19. Rule 6.12 also provides that, while the Exchange may activate more than one trade participation right for an option class (including at different priority sequences), in no case may more than one trade participation right be applied on the same trade. Further, the proposed rule provides that: (1) a DPM’s order or quote must be at the best price on the Exchange; (2) a DPM may not be allocated a total quantity greater than the quantity that it is quoting (including orders not part of quotes) at that price; (3) in establishing the counterparties to a particular trade, the DPM’s participation right must be first counted against its highest priority bids or offers; and (4) the DPM’s participation right will only apply to any remaining balance of

⁹ Cf. CBOE Rule 8.87 (providing a different DPM participation entitlement – 50% if there is one Market-Maker quoting at the BBO, 40% when there are two Market-Makers quoting at the BBO, and 30% when there are three or more Market-Makers quoting at the BBO).

an order once all higher priorities are satisfied. The proposed rule change also adds paragraph (b)(2) to Rule 6.12 to provide for an optional small order priority overlay.

Proposed Rule 8.20 governs the Exchange's authority to terminate, condition, or otherwise limit the approval of a DPM. The proposed rule provides that the Exchange may take such action if the Participant incurs a material financial or operational change, or if it fails to comply with any of the requirements under C2 Chapter 8 regarding DPM obligations. The proposed rule also describes the procedures the Exchange must follow if it chooses to exercise its authority under the proposed rule.

Proposed Rule 8.21 provides that a DPM must maintain information barriers that are reasonably designed to prevent the misuse of material, non-public information with any affiliates that may conduct a brokerage business in option classes allocated to the DPM or act as a specialist or Market-Maker in any security underlying options allocated to the DPM, and otherwise comply with the requirements of CBOE incorporated Rule 4.18 regarding the misuse of material non-public information. The rule also requires a DPM to provide its information barriers to the Exchange and obtain prior written approval.

Finally, the Exchange is amending Rule 17.50(g)(14) to add DPM quoting obligations to the Exchange's Minor Rule Violation Plan ("MRVP").¹⁰

III. Discussion

The Commission finds that the Exchange's proposed rule change to adopt a DPM program on C2 is consistent with the requirements of the Act and the rules and regulations

¹⁰ The CBOE Rule 17.50(g)(14) provides that third and subsequent offenses will be referred to its business conduct committee, unlike the proposed rule change which allows C2 to either fine a Market-Maker \$5,000 for a third or subsequent offense, or refer it to its business conduct committee.

thereunder applicable to a national securities exchange.¹¹ In particular, the Commission believes that the proposal is consistent with the requirements of Section 6(b)(5)¹² of the Act, which require, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and in general, protect investors and the public interest.¹³ Moreover, Section 6(b)(5) requires that the rules of a national securities exchange be designed to not permit unfair discrimination between customers, issuers, brokers or dealers.¹⁴

The Commission finds that the proposed rules are designed to promote just and equitable principles of trade consistent with Section 6(b)(5) of the Act¹⁵ to the extent they require DPMs to undertake certain obligations to the C2 market, including requirements to provide continuous two-sided quoting and meet operational capacity requirements. These requirements should help ensure that DPMs provide liquidity in their allocated classes.

Pursuant to the proposed rules, the transactions of a DPM must constitute a course of dealings reasonably calculated to contribute to the maintenance of a fair and orderly market. A DPM must fulfill all of the obligations of a Market-Maker under C2's rules, and must satisfy the additional requirements imposed on a DPM in the securities allocated to it. In particular, a DPM must, for example: (1) provide continuous quotes in at least the lesser of 99% of the non-adjusted

¹¹ In approving this proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹² 15 U.S.C. 78f(b)(5).

¹³ Id.

¹⁴ Id.

¹⁵ Id.

option series or 100% of the non-adjusted option series minus one call-put pair of each option class allocated to it; (2) assure that each of its displayed market quotations are for the number of contracts required by Rule 8.6(a); (3) make competitive markets on the Exchange; (4) supervise all persons associated with the DPM to assure compliance with the C2 rules; (5) maintain minimum net capital in accordance with C2's rules; (6) maintain information barriers that are reasonably designed to prevent the use of material, non-public information; and (7) continue to act as a DPM and to fulfill all of a DPM's obligations while approved as a DPM. If C2 finds any failure by a DPM to comply with the requirements of C2 Chapter 8 regarding DPM obligations and responsibilities, or if, for any reason, the Exchange believes that a Participant should no longer be eligible to act as a DPM or be allocated particular securities, then C2 may terminate, condition, or otherwise limit a Participant's approval to act as a DPM pursuant to Rule 8.20. Together, these provisions are designed to help assure that DPMs maintain and comply with their obligations to the Exchange and, in so doing, protect investors and the public interest by promoting fair and orderly trading on C2.

Under C2's proposed rules, DPMs would receive certain benefits for their heightened responsibilities. For example, proposed Rule 6.12 allows DPMs to be granted a participation entitlement pursuant to proposed Rule 8.19. A DPM may receive the participation entitlement only when it is one of the Participants quoting at the best price. Further, pursuant to Rule 8.19(b)(3), a DPM will not receive its participation entitlement in trades for which a Preferred Market-Maker receives a participation entitlement. In addition, pursuant to Rule 6.12(b)(2)(B), the small order preference only applies to the allocation of executions among non-customer orders and Market-Maker quotes existing in the Book (i.e., a DPM may not take advantage of

this preference to execute an incoming order for 5 or fewer contracts if there is a customer order resting in the Book).

The Commission believes that a DPM must have sufficient affirmative obligations to justify favorable treatment. The Commission believes that C2's DPM requirements, including those requiring additional liquidity and competitive quoting, impose sufficient affirmative obligations on the Exchange's DPMs, while allowing public customer orders at the best price to continue to be satisfied before a participation entitlement will be applied. Accordingly, the Commission believes that these requirements are consistent with the Act.

The Commission also finds that C2's proposed DPM qualification requirements are consistent with the Act. In particular, the Exchange's rules provide an objective process by which an applicant can become a DPM on the Exchange and are designed to provide for oversight by C2 to monitor for continued compliance by DPMs with the terms of their application for such status and the Exchange's rules. The proposed rules require that the Exchange consider several factors in determining whether to allow a Participant to act as a DPM, including the applicant's adequacy of capital, operational capacity, trading experience, regulatory history, and willingness and ability to promote the Exchange. These factors should ensure that those organizations approved to act as DPMs have the ability to supply liquidity, quote competitively, and perform their obligations competently.

The Exchange also may condition its approval for an applicant's DPM status, including by imposing conditions on the capital or operations of the applicant or the number of securities allocated to the applicant, which should contribute to the Exchange's ability to ensure that a DPM applicant is able to perform its DPM functions. The Commission believes that the financial requirements for DPMs proposed by the Exchange are designed to promote investor

protection by ensuring that DPMs have sufficient capital to maintain an orderly market for their allocated securities.

Finally, the Commission believes that the Exchange's proposed procedures for allocating securities to DPMs should help to ensure that securities traded by the Exchange are allocated in an equitable manner, giving all DPMs a fair opportunity to obtain allocations. In addition, the Commission believes that the Exchange's proposed rule limiting each DPM's term to one year should open opportunities to all Participants to become a DPM.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁶ that the proposed rule change (SR-C2-2012-024) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁷

Kevin M. O'Neill
Deputy Secretary

¹⁶ 15 U.S.C. 78s(b)(2).

¹⁷ 17 CFR 200.30-3(a)(12).