

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 69726 / June 11, 2013**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-15353**

**In the Matter of**

**Chicago Board Options Exchange,  
Incorporated and  
C2 Options Exchange, Incorporated,**

**Respondents.**

**ORDER INSTITUTING ADMINISTRATIVE  
AND CEASE-AND-DESIST PROCEEDINGS  
PURSUANT TO SECTIONS 19(h)(1) AND 21C  
OF THE SECURITIES EXCHANGE ACT OF  
1934, MAKING FINDINGS AND IMPOSING  
SANCTIONS AND A CEASE-AND-DESIST  
ORDER**

**I.**

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 19(h)(1) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”) against Chicago Board Options Exchange, Incorporated (“CBOE” or the “Exchange”) and C2 Options Exchange, Incorporated (“C2”) (collectively, “Respondents”).

**II.**

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the “Offers”) that the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 19(h)(1) and 21C of the Securities Exchange Act of 1934, Making Findings and Imposing Sanctions and a Cease-and-Desist Order (“Order”), as set forth below.

### III.

On the basis of this Order and Respondents' Offers, the Commission finds<sup>1</sup> that:

#### SUMMARY

Self-regulation is a unique and fundamental component of federal securities regulation in the United States. The principal markets where securities are bought and sold — the nation's securities exchanges — are also the principal regulators of the activities of broker-dealers using those markets. With the benefits of operating an exchange come certain regulatory responsibilities. In order to exist as a registered national securities exchange or securities association, an exchange or association must fulfill certain well-established regulatory obligations as a self-regulatory organization ("SRO"). An SRO must comply with, and enforce its members' compliance with, the federal securities laws and rules, as well as its own rules. In this regard, an SRO must conduct surveillance of trading on its exchanges and examine the securities-related operations of its members. An SRO must also file proposed rules and rule changes governing its operations with the Commission. Among other requirements, an SRO's rules must provide for the equitable allocation of reasonable dues, fees and other charges among exchange or association members or other persons using the SRO's facilities and must not be designed to permit unfair discrimination between customers, issuers, brokers or dealers.

In spite of these well-established obligations, an inherent conflict exists within every SRO between the regulation of its members and its business interests, as well as the potential for unfair discrimination among members. The Commission has recognized that unchecked conflicts in the dual role of regulating and serving members can result in under zealous enforcement of rules against members and less robust rulemaking.

[E]ven where an SRO structure may appear sound, successful self-regulation relies on sufficiently vigorous rule enforcement against members on the part of the SRO. If regulatory staff is disinclined to regulate members, self-regulation will fail. Thus, to be effective, an SRO must be structured in such a way that regulatory staff is unencumbered by inappropriate business pressure.

*Concept Release Concerning Self-Regulation*, 69 Fed. Reg. 71256, 71259 (Dec. 8, 2004).

This matter concerns the failure of a self-regulatory organization to police and control this conflict and prevent the advancement of its business interests, and the interests of its member firms, ahead of its regulatory obligations.

The Chicago Board Options Exchange ("CBOE" or the "Exchange") failed to fulfill its fundamental responsibilities as an SRO and exchange. CBOE's failures were not mere oversights or technical violations, but a systemic breakdown in several of its regulatory and

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<sup>1</sup> The findings herein are made pursuant to the Respondents' Offers and are not binding on any other person or entity in this or any other proceeding.

compliance responsibilities as an exchange. Not only did it fail to enforce the Commission’s rules by not adequately investigating a member firm’s compliance with Regulation SHO of the Exchange Act (“Reg. SHO”), CBOE’s conduct also interfered with the Commission’s Division of Enforcement (“Enforcement Division”) staff’s Reg. SHO investigation of the same member firm. This conduct was egregious. CBOE assisted that member firm by taking the unprecedented step of providing information for, and edits to, the member firm’s Wells submission<sup>2</sup> to the Commission — even more troubling, the information and edits provided by CBOE resulted in the member firm providing the Commission with inaccurate and misleading information. When questioned by Enforcement Division staff about the underlying matter, CBOE failed to disclose that it had assisted the member firm with its Wells submission. CBOE also failed to enforce Reg. SHO because it employed a Reg. SHO surveillance program that failed to detect a single violation, despite numerous red flags that its members engaged in violative conduct.

CBOE’s failures cut across all aspects of its regulatory, business and exchange operations. In addition to failing to adequately enforce the Commission’s rules, CBOE failed to adequately enforce its own rules, including its firm quote and priority rules, as well as rules governing registration of persons associated with proprietary trading member firms. In addition, by making unauthorized “customer accommodations,” rebates, and other credits to certain member firms<sup>3</sup> and not others without an applicable rule in place that was consistent with the applicable statutory standards, CBOE failed to provide for the equitable allocation of fees and other charges and engaged in unfair discrimination between member firms. Furthermore, CBOE and C2 failed to file proposed rule changes or filed proposed rule changes long after, and in some instances years after, certain trading functions had been in effect. Lastly, CBOE failed to promptly furnish complete and accurate business records on a timely basis at Commission staff’s request.

As a result of its conduct, CBOE violated Sections 17(a), 19(b)(1), and 19(g)(1) of the Exchange Act, and Rule 17a-1 thereunder, and C2 violated Section 19(b)(1).

In response to the Commission’s investigation, CBOE voluntarily entered into a comprehensive program of remediation to address the issues that had weakened its ability to operate as an SRO and undertook several initiatives to improve the Exchange’s performance and operations, including changes to its regulatory, compliance, and corporate governance structure.

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<sup>2</sup> A Wells submission is a memorandum or video in which a witness in a Commission investigation makes factual, legal or policy arguments in response to a Wells notice from the Commission’s Enforcement Division staff in an effort to persuade the Commission not to charge them with federal securities violations. The Wells notice informs the person or entity (1) that the Division of Enforcement is considering recommending or intends to recommend that the Commission file an action or proceeding against them; (2) the potential violations at issue in the recommendation; and (3) that the person or entity may submit arguments or evidence (the “Wells submission”) to Enforcement and the Commission regarding the recommendation and evidence.

<sup>3</sup> Member firms of CBOE and CBOE Stock Exchange (“CBSX”), a stock trading facility owned by CBOE and a consortium of financial entities, are now referred to as trading permit holders.

## RESPONDENTS

1. **Chicago Board Options Exchange, Incorporated (“CBOE”)** is a Delaware corporation with its principal place of business in Chicago, Illinois. CBOE is registered with the Commission as a national securities exchange pursuant to Section 6 of the Exchange Act. CBOE provides regulatory services to several other exchanges pursuant to Regulatory Services Agreements. CBOE is a wholly-owned subsidiary of CBOE Holdings, Inc., a publicly-traded company. The Commission previously brought two actions against CBOE for failure to enforce its rules.<sup>4</sup>

2. **C2 Options Exchange, Incorporated (“C2”)** is a Delaware corporation with its principal place of business in Chicago, Illinois. C2 is registered with the Commission as a national securities exchange pursuant to Section 6 of the Exchange Act. C2 is a wholly-owned subsidiary of CBOE Holdings, Inc.

## FACTS

3. CBOE engaged in conduct that violated laws and rules regulating SROs. Specifically, the Exchange, in several instances: (i) failed to adequately enforce the federal securities laws and regulations and its own rules, (ii) engaged in conduct that interfered with a Commission investigation and failed to timely provide information requested by Commission staff, and (iii) engaged in certain conduct without effective rules in place. Further, C2 also violated the laws and rules regulating SROs by failing to file proposed rule changes until after it had implemented certain trading functions.

### Failure to Adequately Enforce the Federal Securities Laws, the Commission’s Rules and CBOE Rules

4. Section 19(g)(1) of the Exchange Act requires every exchange to comply with the provisions of the Exchange Act, the rules and regulations thereunder, and its own rules, as well as to enforce compliance by its members with such provision, rules and regulations. CBOE failed to adequately enforce compliance with Reg. SHO and then engaged in unprecedented conduct that interfered with Commission staff’s Reg. SHO investigation. In addition, CBOE failed to enforce its own rules in at least three areas: (i) firm quote and priority rules; (ii) registration; and (iii) access to CBSX.

### **CBOE Failed to Adequately Enforce Regulation SHO of the Exchange Act**

5. Rules 204 and 204T of Reg. SHO deal with the requirement to close-out failures to deliver. Rule 204T became effective on September 18, 2008 and Rule 204 became effective on July

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<sup>4</sup> *In the Matter of the Chicago Board Options Exchange, Inc.*, Exchange Act Release No. 26809, 1989 WL 991541 (May 11, 1989) (settled matter) (finding that CBOE failed to enforce its rules); *In the Matter of Certain Activities of Options Exchanges*, Exchange Act Release No. 43268, 2000 WL 1277616 (Sept. 11, 2000) (settled matter) (finding that CBOE failed to enforce its rules).

31, 2009.<sup>5</sup> Rules 204 and 204T require clearing firms to deliver equity securities to a registered clearing agency when delivery is due; that is, by settlement date, which is generally three days after the trade date (“T+3”). For short sales, if the clearing firm does not deliver securities by T+3 and it has a failure-to-deliver position at the clearing agency, it must purchase or borrow securities of like kind and quantity to close out the failure-to-deliver position by no later than the beginning of regular trading hours on the settlement day following the settlement date (“T+4”).

6. In 2008, CBOE moved its surveillance and monitoring of Reg. SHO compliance from the Department of Regulated Entities to the Department of Market Regulation (“DMR”).<sup>6</sup> The transfer of responsibilities to DMR adversely affected CBOE’s Reg. SHO enforcement program. Since that transfer, CBOE’s DMR has not taken action against any firm for violations of Reg. SHO as a result of the Reg. SHO surveillance or complaints from third parties. CBOE failed to adequately enforce Reg. SHO because its staff lacked a fundamental understanding of the rule, it provided no training to regulatory staff, and it failed to follow existing policies and procedures.

*CBOE’s Surveillance Program Failed to Adequately  
Detect, Investigate and Discipline Reg. SHO Violations*

7. CBOE’s DMR developed policies and procedures for its surveillance program to identify and investigate instances in which market participants used options or options strategies to circumvent Reg. SHO Rules 204 and 204T by giving the appearance of having purchased shares to close-out an open failure-to-deliver position while in fact not doing so.

8. These policies and procedures required CBOE to generate an exception report on a quarterly basis and to surveil for trades that fell within certain predetermined parameters (known as “exceptions”) for “suspicious scenarios.” The procedures then required the investigator assigned to the surveillance to contact the member firms responsible for the exceptions and request certain information. After reviewing the information requested, the investigator was to determine whether the firms were utilizing options to circumvent Reg. SHO’s close-out requirements.

9. If, after reviewing all the information supplied by the firms, the investigator determined that there was no circumvention, the investigator would recommend that the inquiry be closed. The procedures required the investigator’s supervisor, prior to formally closing the inquiry, to review and approve the investigator’s recommendation and case file to ensure accuracy and validate the staff’s analysis.

10. These policies and procedures were not followed by CBOE’s DMR. For example, in January 2010, CBOE’s Reg. SHO surveillance generated 75 exceptions in several securities for one member firm in the third and fourth quarters of 2009. As a result, CBOE sent a letter to the

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<sup>5</sup> Rule 204T, the “temporary” Reg. SHO rule, was made permanent, with some modifications, through the adoption of Rule 204.

<sup>6</sup> DMR was one of several departments within CBOE’s Member and Regulatory Services Division. During the same period, the former head of DMR reported to CBOE’s Chief Regulatory Officer (“CRO”). The CRO reported to the former head of the Member and Regulatory Services Division, who reported to CBOE’s former President and Chief Operating Officer.

member firm requesting additional information concerning those transactions. The member, which was a self-clearing firm, provided documents to CBOE which demonstrated that, for each of the securities involved, the firm had a failure to deliver position for a number of consecutive settlement days, indicating that it was potentially not in compliance with Reg. SHO. However, CBOE staff failed to adequately review, much less understand the import of, this information to determine whether the member firm was in fact attempting to circumvent its close-out obligations. Indeed, this was the first time that staff assigned to the surveillance had seen such information.

11. Instead, CBOE took no action against the member firm as a result of these surveillance exceptions and closed the inquiry merely because the firm had represented to the Exchange that it did not receive any buy-ins for the securities involved. CBOE did nothing to investigate the firm's representation.<sup>7</sup>

12. Accordingly, in December 2010, CBOE sent two "filed without action" letters to the member firm stating that CBOE had completed its inquiry into whether the member firm had violated Reg. SHO Rules 204 and 204T and "determined that no violations of the Securities and Exchange Commission or Exchange rules were apparent with respect to the materials reviewed in conjunction with this inquiry." CBOE sent these letters despite the fact that the materials it purportedly reviewed showed that the member firm had ongoing failures to deliver.

13. Inquiries related to all other firms that had exceptions generated by the Reg. SHO surveillance were handled in a similar manner by CBOE.

14. Moreover, CBOE failed to properly train its investigative staff on short sales and Reg. SHO. For instance, CBOE staff responsible for the Exchange's Reg. SHO surveillance never received any formal training on Reg. SHO, were instructed to read the rules themselves, did not have a basic understanding of what a failure to deliver was, and were unaware of the relationship between failures to deliver and a clearing firm's net short position at the Depository Trust and Clearing Corporation ("DTCC").<sup>8</sup> In fact, the investigator primarily responsible for monitoring the Reg. SHO surveillance from the third quarter 2009 to the second quarter 2010 had never even read the rule in its entirety, but only briefly perused it.

15. As a result, CBOE's DMR has not taken action against any firm for violations of Reg. SHO as a result of the Reg. SHO surveillance, or complaints from third parties, since the Reg. SHO surveillance went into effect in the third quarter 2009.

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<sup>7</sup> CBOE's DMR took the representations of another member firm at face value as well. In that instance, the member firm, a clearing broker, had represented to CBOE in an interview that it had policies and procedures in place to prevent Reg. SHO violations. Based solely on those representations, CBOE updated its Reg. SHO surveillance manual to state that exceptions generated by the market maker clients of this particular member firm would be "disregard[ed]."

<sup>8</sup> Virtually all equities securities trades in the United States are cleared and settled through the National Securities Clearing Corporation (NSCC) and the Depository Trust Company (DTC), clearing agency subsidiaries of the DTCC.

*CBOE Failed to Adequately Investigate Reg. SHO Violations of A Member Firm*

16. In February 2009, CBOE's DMR received a complaint concerning possible short sale violations involving a customer account at the same member firm discussed above and began investigating whether the trading activity violated Rule 204T of Reg. SHO. However, CBOE staff conducting the investigation lacked the most basic understanding of Rule 204T.

17. In particular, CBOE staff assigned to the case did not know what a failure to deliver was, did not know how to determine if a fail existed, and were confused as to whether Reg. SHO applied to a retail customer.

18. As part of its investigation, CBOE staff sought guidance from Commission staff. In doing so, however, CBOE erroneously focused on whether the member firm's customer, as opposed to the member firm itself, was in violation of Reg. SHO and erroneously represented to the Division of Trading and Markets ("Trading and Markets") that there were no failures to deliver associated with the trading at issue. Based on CBOE's representations, Trading and Markets advised CBOE on a call that if there were no failures to deliver, then there was no Reg. SHO violation, and that there was no violation on the part of the customer because customers cannot violate Reg. SHO. Trading and Markets also suggested to CBOE on the call that it consider whether the customer's trading activity was fraudulent.

19. CBOE did not undertake more than a cursory analysis of the trading to determine if it was fraudulent and never considered the applicability of Rule 10b-21 of the Exchange Act, the anti-fraud short-selling rule that was promulgated together with Rule 204T. CBOE staff provided a written memorandum to the Commission's Enforcement Division purporting to analyze the trading and ultimately decided to refer the matter to the Enforcement Division as a formal advisory; however, no referral was made.

20. Because CBOE focused almost exclusively on the customer's activity and wrongly concluded that there were no failures to deliver associated with the trading, it never investigated whether the member firm itself was properly fulfilling its close-out obligations under Reg. SHO. As a result, CBOE formally closed the investigation in September 2009 and only issued the member firm a letter of caution based on a technical deviation from the firm's buy-in procedures.

21. In the course of closing its Reg. SHO investigation, CBOE staff finalized an internal investigative report dated September 23, 2009, purporting to document the reasons CBOE closed the case. However, the information contained in the report was inaccurate in that it erroneously attributed guidance to Trading and Markets that was never given. The report also failed to disclose that Trading and Markets informed CBOE that there was no Reg. SHO violation on the part of the member firm's customer because customers cannot violate Reg. SHO and that Trading and Markets provided no guidance as to whether the member firm itself violated Reg. SHO.

*CBOE Interfered, and Failed to Cooperate, with the Commission Staff's Reg. SHO Investigation*

22. Not only did CBOE fail to adequately detect violations and investigate and discipline one of its members, CBOE also took misguided and unprecedented steps to assist that same member which was under investigation by the Commission's Enforcement Division staff and failed to provide information to Commission staff when requested.

23. Commission staff began investigating one of CBOE's member firms and some of its customers for potential Reg. SHO and fraud violations in December 2009. Commission staff informed the former head of CBOE's DMR of its investigation on February 1, 2010 and requested, among other data, exception data from CBOE's Reg. SHO surveillance for the third and fourth quarter of 2009.

24. CBOE's Chief Regulatory Officer ("CRO") responded in a February 3, 2010 letter that contained factual inaccuracies as to guidance received from Trading and Markets regarding CBOE's earlier Reg. SHO investigation involving the same member firm. Among other things, the letter failed to disclose that Trading and Markets gave no definitive guidance to CBOE as to whether the member firm violated Reg. SHO, based on the information that CBOE provided. Moreover, the letter incorrectly stated that CBOE had "initially been inclined to take formal disciplinary action against [the member firm]" and failed to explain why the trading activity was not referred to the Commission.

25. The letter was drafted by the CRO's supervisor, who was the former head of CBOE's Member and Regulatory Services Division, and was reviewed by the former head of CBOE's DMR who failed to correct the letter's inaccuracies prior to it being sent to Commission staff. Moreover, CBOE did not provide the surveillance exception data for the third and fourth quarters 2009 as requested by Commission staff.

26. A month later, the same member firm requested CBOE's assistance in advocating before Commission staff concerning its investigation. In particular, the member firm asked the head of CBOE's Department of Member Firm Regulation ("DMFR") to get the Commission to "back off" its investigation. This request was discussed internally by senior business executives at CBOE, including its former President and Chief Operating Officer. In fact, the former President and Chief Operating Officer asked DMFR's head to facilitate a conference call with the member firm.

27. As a result, on March 9, 2010, DMFR's head told the member firm that CBOE would discuss the issue internally to determine if there was anything CBOE could do to assist the member firm. Later that day, DMFR's head and a CBOE colleague held a conference call with senior officers at the member firm. The member firm explained that it was the subject of a Commission investigation involving Reg. SHO and asked CBOE to intercede on its behalf and tell the Commission that the trading activity at issue was acceptable. The head of DMFR responded that, in his view, CBOE should not intercede and that the Commission was CBOE's regulator and could conduct an oversight inspection of CBOE. Nonetheless, he told the member firm that it would discuss the issue internally and get back to the member firm.



28. Ultimately, CBOE declined the member firm's request and informed the member firm that it would not advocate on its behalf with respect to the Commission's investigation. Upon learning of this decision, CBOE's former President and Chief Operating Officer emailed the head of DMFR: "Thanks. Showing that we tried helps. We can't solve everyone's problems. I appreciate it."

29. During this time, CBOE still had not provided the exception data from its Reg. SHO surveillance as requested by Commission staff.

30. In September 2010, the former head of CBOE's Member and Regulatory Services Division proposed that CBOE hold a senior-level meeting with the member firm over concerns that had developed about the relationship between the member firm and CBOE, including the firm's lack of cooperation in CBOE examinations and other related issues. The former head of CBOE's Member and Regulatory Services Division prepared a written summary of those concerns that was emailed to CBOE's former President and Chief Operating Officer on October 26, 2010. CBOE's former President and Chief Operating Officer agreed to set up a meeting with the CEO of the member firm, who was, at the time, also a member of CBOE's Board of Directors and sat on CBOE's Audit Committee, to discuss CBOE's concerns.<sup>9</sup>

31. Two weeks later, in November 2010, CBOE's former President and Chief Operating Officer and the former head of CBOE's Member and Regulatory Services Division met with the member firm's CEO. During the meeting, the Commission's investigation of the member firm was discussed. According to the member firm's CEO, he was informed that it was CBOE's position that the trading activity under investigation was appropriate under Reg. SHO — which contrasted with the information that CBOE provided to Commission staff both before and after November 2010. The member firm's CEO was also informed that CBOE reached out to Trading and Markets and was told that Trading and Markets agreed with CBOE's view of the trading, information which was not accurate.

32. Shortly thereafter, on December 3, 2010, the member firm's in-house counsel called the former head of CBOE's Member and Regulatory Services Division and requested information that would assist the member firm in responding to the Commission investigation. Specifically, the member firm's in-house counsel explained that the member firm and four of its officers had received Wells notices from Commission staff and that she had become aware that CBOE had communicated with Trading and Markets about the trading. She then requested that the member firm be allowed to look at CBOE's investigative file or be provided a copy of it.

33. On December 6, 2010, the former head of CBOE's Member and Regulatory Services Division told the member firm's in-house counsel that CBOE would not provide a copy of the file, but would provide a summary of events and to the extent that the member firm wanted to include that information in its Wells submission, CBOE would review the submission and respond. He then provided a summary of the events to the member firm's in-house counsel, including inaccurate information about communications CBOE had with Trading and Markets. The former head of CBOE's Member and Regulatory Services Division provided this summary despite

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<sup>9</sup> The member firm's CEO has not been a member of either CBOE's Board or Audit Committee since October 2011.

knowing that CBOE investigations, and information obtained from other regulators during those investigations, were to be kept confidential.

34. On December 9, 2010, the member firm emailed the former head of CBOE's Member and Regulatory Services Division an excerpt from a draft Wells response it intended to submit in connection with the Commission's Reg. SHO investigation. The member firm asked CBOE to provide "review, modification and insight" into the Wells submission excerpt. The excerpt contained details of CBOE's investigation and CBOE's purported communications with Trading and Markets, and was being used by the member firm for exculpatory purposes. That Wells submission excerpt, however, contained numerous factual inaccuracies, most notably the erroneous description of guidance received from Trading and Markets.

35. The former head of CBOE's Member and Regulatory Services Division edited the excerpt "to clarify the record" and forwarded it for review to senior members of the Regulatory Services Division, including the head of DMFR and the former head of DMR, who participated on CBOE's calls with Trading and Markets. The excerpt, as edited by CBOE, incorrectly stated that Trading and Markets informed CBOE that Trading and Markets did not believe that the member firm violated Reg. SHO. The former head of the Member and Regulatory Services Division then emailed the "redline" edits to the member firm, despite the CRO's recommendation that CBOE not get involved with the member's Wells submission.

36. CBOE's edits failed to correct the excerpt's factual inaccuracies and included the erroneous attribution of guidance to Trading and Markets.

37. After receiving CBOE's edits of the Wells submission, the member firm's in-house counsel thanked CBOE for following up so quickly and said that CBOE "truly has gone above and beyond."

38. The member firm provided its Wells submission to Commission staff on December 12, 2010. It contained language which was substantially similar to the edits that CBOE had provided.

39. At the time of the Wells submission, CBOE still had not provided the exception data from its Reg. SHO surveillance as requested by Commission staff and did not inform Commission staff of the two December 2010 "file without action" letters, discussed in paragraph 12 above, that CBOE had just issued to the member firm. The two letters were discussed for exculpatory purposes and included as exhibits in the member firm's Wells and supplemental Wells submissions to the Commission.

40. After receiving the Wells submission, Commission staff held a conference call in January 2011 with the former heads of the Member and Regulatory Services Division and DMR and the CRO, all of whom were aware that CBOE had provided input to the member firm's Wells submission, as well as CBOE's in-house enforcement counsel. Commission staff asked about various aspects of CBOE's relationship with the member firm and CBOE's Reg. SHO investigation of that member firm, the basis and timing of the two December 2010 "file without action" letters, CBOE's continuing failure to provide staff with the Reg. SHO exception reports, and the statements

in CBOE's February 3, 2010 letter to staff. On the call, CBOE admitted that some of the statements in the February 3, 2010 letter regarding CBOE's communications with Trading and Markets were factually incorrect. At no time during the call did anyone from CBOE disclose the fact that CBOE had reviewed and edited a portion of the member firm's Wells submission.

41. On January 28, 2011, CBOE produced documents in response to a document request by the Commission's Enforcement Division staff. Included in those documents were CBOE's edits to the member firm's Wells submission and related emails. The discovery of those documents was the first time that Commission staff became aware that CBOE had reviewed and edited the Wells submission.

### **CBOE Failed to Adequately Enforce Its Firm Quote and Priority Rules**

42. Since 2003, CBOE has operated a Hybrid Trading System which combines electronic trading and open outcry trading. Unlike options traded electronically (via automatic execution, electronic auction, or automatic routing to another market), options traded in open outcry (where traders on the trading floor call out their orders or use hand signals to negotiate orders) require manual handling by floor traders or Exchange employees on the Exchange floor. For such trades, CBOE uses automated surveillance programs to assess whether floor traders and Exchange employees comply with CBOE's firm quote and priority rules.

43. However, CBOE's automated surveillance programs for manually handled trades were ineffective because (i) the programs were too narrowly focused in that they did not cover a majority of potential rule violations or they excluded numerous order types and order handling scenarios from evaluation, (ii) the programs failed to incorporate necessary information, (iii) CBOE's investigative staff did not have a comprehensive understanding of the logic underlying the automated surveillance programs, and (iv) the procedures manual and requirements documents that CBOE maintained for the automated surveillance programs in the course of conducting its self-regulatory activity were inaccurate and incomplete as they did not include a comprehensive, reliable, or easily accessible description of the underlying surveillance logic.

44. As a result of these deficiencies, a review of CBOE's firm quote investigation files dating back to April 2002 showed that of the 63 firm quote investigation files reviewed, only six were generated from the automated surveillances. The remaining files were complaint driven. In addition, none of the 63 firm quote investigations resulted in any disciplinary actions.

45. In addition, CBOE was unable to promptly furnish Commission staff with complete and accurate records concerning its surveillance logic for its firm quote and priority rule violation automated surveillance programs for manually handled orders and trades.

### **CBOE Failed to Adequately Enforce Its Registration Rules**

46. In 2010, the Commission approved CBOE rule changes governing the registration and qualification of persons associated with proprietary trading firms that were CBOE members. The rules required such associated persons to pass a qualification examination, but authorized

CBOE to waive that requirement in exceptional circumstances and for good cause shown. CBOE failed to rigorously enforce this rule.

47. On June 3, 2009, Trading and Markets sent a letter to the exchanges, including CBOE, asking them to ensure that their rules required all associated persons of members to be registered through the Form U4, qualified by passing an appropriate examination, and subject to training and continuing education requirements. Trading and Markets requested that the exchanges file rules to address any gaps in their registration requirements by July 3, 2009.

48. Following lengthy discussions with Commission staff over concerns regarding CBOE's handling of these registration requirements and the submission of several draft rule filings, CBOE filed its proposed rule change on September 10, 2010. The Commission approved the rule change on November 12, 2010. As amended, CBOE's rules required all associated persons of its members engaged in a securities business on CBOE or on its stock trading facility, CBSX, as well as those who supervise those persons, to register with the Exchange, qualify by passing an appropriate examination, and comply with continuing education requirements. CBOE's rules permitted CBOE to waive the examination requirement "in exceptional cases and where good cause is shown" by the applicant. In the course of its business, CBOE maintained registration records concerning persons associated with proprietary trading firms, including records relating to waivers that were requested and granted.

49. The Commission order approving the rule change required: (1) CBOE members to register associated persons by January 11, 2011; (2) CBOE to develop and file the new examination by May 12, 2011; and (3) the associated persons to pass the examination by August 12, 2011. However, CBOE requested extensions to the registration and examination deadlines for associated persons on several occasions.

50. During the summer of 2009, Trading and Markets asked CBOE the number of associated persons that would be implicated by the new requirements. CBOE was unable to answer this question. Trading and Markets later asked CBOE for the number of waivers it had granted. CBOE was also unable to promptly furnish a consistent, accurate, and reliable answer to this question from its records. Indeed, CBOE provided several inconsistent and contradictory responses.

51. Based on the information it was able to provide, CBOE granted a substantial number of waiver requests it had received as of January 31, 2012. For example, for the proprietary trader examination, CBOE granted 2,215 of the 2,801 valid waiver requests. For the proprietary trader compliance officer examination, CBOE granted 118 of the 168 valid waiver requests. For the proprietary trader principal examination, CBOE granted 352 of the 503 valid waiver requests. When granting waiver requests both before and after January 31, 2012, CBOE failed to adequately consider whether the circumstances under which the waivers were granted met the standard in its rule permitting CBOE to grant waivers only in exceptional circumstances where good cause was demonstrated by the applicants.<sup>10</sup>

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<sup>10</sup> These numbers include 496 proprietary trader, 291 proprietary trader principal, and 44 proprietary trader compliance officer waiver requests that CBOE later determined were unnecessary.

52. CBOE's internal procedures were insufficient to ensure that waiver determinations would be made consistent with CBOE Rule 3.6A which permits CBOE to grant waivers only in exceptional cases, where good cause was shown. Moreover, CBOE's records of the reasons for granting or denying waivers were not detailed enough to provide a reliable audit trail of the rationale for CBOE's waiver determinations.

### **CBOE Failed to Adequately Monitor and Surveil CBSX**

53. CBOE failed to adequately monitor and surveil CBSX because CBOE failed to maintain a reliable or accurate audit trail of orders submitted by CBSX members on that exchange facility. Specifically, the audit trail did not capture the identity of those members who CBSX allowed access to its exchange facility when this connectivity was provided through non-member entities such as service bureaus, but instead aggregated those trades. As a result, CBOE could not reliably and accurately determine which CBSX members were providing access for orders.

54. Because of CBOE's inability to determine who was responsible for granting access to CBSX, CBOE failed to adequately monitor that exchange facility for enforcement, and surveil for potential violations, of the Commission's and the Exchange's rules. For example, CBOE regulatory staff noted that certain surveillance parameters were based on the aggregate data approach used by CBSX for its order audit trail and not on a member-by-member level.

### **Business Interference with a Regulatory Matter**

55. CBOE's Regulatory Services Division is responsible for enforcing the federal securities laws and regulations and CBOE rules. Until recently, CBOE had no formal policies separating its Regulatory Services Division from its business side, which was responsible for CBOE's income generation. In fact, until recently, CBOE's Chief Regulatory Officer reported up to a senior business executive. As a result, the line between business and regulation became blurred.

56. An example of that potential for blurred boundaries occurred in late 2009, when, as part of its routine portfolio margining examination of the same member firm which was subject to the Reg. SHO investigation above, CBOE's DMFR began asking questions about a particular portfolio margin account which had a significant amount of trading activity.

57. The member firm informed CBOE that the account was not a proprietary trading account, but an account of an affiliate that de-registered as a broker-dealer, but continued its trading activities as a portfolio margin customer of the firm.

58. DMFR continued to investigate the trading activities of the affiliate and later informed the member firm in June 2010 that it believed the affiliate was functioning as a dealer and thus needed to be registered. Subsequently, in July 2010, the affiliate filed an application for registration with the Commission and was granted conditional approval. For its Commission registration to become effective, the affiliate was required to be a member of FINRA or an exchange.

59. As of early October 2010, the affiliate had yet to become a member of FINRA or an exchange. As a result of the affiliate's delay, the DMFR planned to issue the member firm a CBOE Wells notice for operating a non-registered dealer.

60. When informed of this development by the former head of Member and Regulatory Services, who oversaw the DMFR, CBOE's former President and Chief Operating Officer asked that the Wells notice not be issued until after an upcoming meeting with the member firm's CEO, who, at the time, sat on CBOE's Board and its Audit Committee. The purpose of that meeting, as described above, was to review the firm's conduct and regulatory compliance.

61. Shortly after the meeting, the affiliate of the member firm completed its registration as a dealer. CBOE issued no Wells notice either to the member firm or to the affiliate concerning the registration issue.

### **Failure to File Rules**

62. Section 19(b)(1) of the Exchange Act requires every exchange to file proposed rules or rule changes (collectively "proposed rule changes") with the Commission and for the Commission to publish notice of the proposed rule changes and to give interested persons an opportunity to submit written data, views, and arguments. Section 19(b)(1) further provides that "[n]o proposed rule change shall take effect unless approved by the Commission or otherwise permitted in accordance with the provisions of this subsection."

### **Financial Accommodations to Only Certain Members**

63. In 2008, the Commission's Office of Compliance Inspections and Examinations ("OCIE") conducted a special inspection of CBOE's billing and collection practices. The inspection staff learned that CBOE lacked written policies and procedures that were sufficiently defined to deter intentional or inadvertent discriminatory billing and collection practices and suggested that its fee functions would benefit from greater management oversight.

64. In response, CBOE developed and implemented written policies and procedures concerning its billing and collection process which it provided to OCIE on November 10, 2008. According to CBOE, its procedures were designed to (1) better ensure that all fees were uniformly assessed and collected in accordance with Exchange rules; (2) reduce unnecessary discretion regarding disputes, adjustments, credits, past due balances and sanctions; and (3) provide better regulatory oversight of these functions to facilitate compliance and deter disparate or discriminatory treatment.

65. Despite these new procedures, CBOE made several financial accommodations to certain members, and not to others, that were not authorized by existing rules.<sup>11</sup> These

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<sup>11</sup> Pursuant to Sections 6(b)(4) and (5) of the Exchange Act, national securities exchange rules must "provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other

accommodations were not offered to all member firms. The accommodations were made for business reasons and were authorized by senior CBOE business executives who lacked an understanding of CBOE's legal obligations as a self-regulatory organization.

66. After Commission staff expressed concern regarding CBOE's accommodation to the same member firm which was subject to the Reg. SHO investigation above, CBOE discovered and self-reported additional instances of financial accommodations to certain members, as described below. As part of that internal review, CBOE hired outside counsel to investigate such practices and discontinued these practices where not authorized by rule.

*Payments to a Member Firm for the Firm's Own Preference Errors*

67. In 2008, CBOE introduced a new routing system which allowed member firms to direct (or "preference") their orders to preferred market makers by identifying their preference on each order. Under the old routing system, firms could preference their orders, but did not have to identify their preferences on each order because the orders would default to a table which would look up the firms' preferences and add them to the orders. CBOE issued a circular introducing the new routing system that stated that orders under the new routing system bypassed the old routing system and that the routing parameters for the old system no longer applied.

68. In 2009, a member firm asked CBOE about lower-than-expected payments for order flow. CBOE determined that the firm had not been identifying preferred market makers on its orders under the new routing system. Because the firm did not indicate its preferences on its orders, control of any marketing fee/pool dollars was given to the designated primary market maker and not to the firm. As a result, approximately \$2.8 million in marketing fee/pool dollars was paid to the designated market maker during the July 2008 through March 2009 time period, instead of the member firm.

69. The member firm claimed it was unaware of the new procedures. Although CBOE took the position that the firm was on notice, CBOE nonetheless agreed to "reimburse" the firm up to \$1.2 million (over seven monthly payments) in return for the firm increasing its order flow for each of those months. CBOE ultimately made five payments to the member firm totaling \$857,000. These payments were not made pursuant to any rule. CBOE did not offer similar accommodations to other firms. Senior business executives at CBOE were responsible for the agreement.

70. One of the senior executives who approved the payments at one point asked a CBOE analyst whether the Exchange could apply some of the collected funds to the member firm as if the firm had gone through the preferencing table, similar to what was done in another matter. The analyst responded that although she could figure out how to manually override the data, she "would feel very uncomfortable doing so." She explained that the other matter was done "because of a discovered error. In this case, even if it was not clearly stated, it wouldn't be technically fixing an error. In addition, I could not do this override for all firms, and if we did it

persons using its facilities" and that are "not designed to permit unfair discrimination between customers, issuers, brokers, or dealers."

for the member firm [which requested the accommodation] [I] suspect that the SEC, if they ever audit my process, would say that we were playing favorites.”

#### CBOE and CBSX Use of Error Accounts

71. CBOE maintained error accounts at two brokerage firms through which the Exchange conducted trades to compensate member firms for errors as well as to make “accommodation payments.” CBSX also maintained an error account at one of the brokerage firms.

72. To fix an error or to make an accommodation payment through the error accounts, CBOE’s execution services department would write trade tickets into one of the error accounts. The counterparty would do the same. CBOE had no rules in place permitting these actions.

73. Between September 2006 and October 2011, approximately 2,800 transactions were processed through CBOE error accounts for a net loss to CBOE of approximately \$496,000. For the period May 2007 through September 2011, approximately 1,100 transactions were processed through the CBSX error account for a net gain to CBSX of approximately \$131,000.

74. While it is unclear what percentage of the transactions in the error accounts were bona fide errors and what percentage were accommodation payments (*i.e.*, non-bona fide errors), there were no rules in place which permitted the use of the error accounts and the error accounts were used to compensate certain member firms for non-bona fide errors.

75. Senior management at CBOE knew about the error accounts and how they operated. The process for resolving the errors was well documented and subject to internal controls.

76. Beginning in mid-2009, information relating to trades in the error accounts was sent to CBOE’s DMR, which questioned whether certain of the trades were appropriate. However, no action was taken.

#### Direct Accommodation Payments and Credits

77. CBOE also made direct accommodation payments or gave credits to member firms. The accommodation payments generally arose when certain members complained about mistakes they made in designating their orders, resulting in higher fees. The accommodations were usually a percentage of the difference between the fees charged and the lower fees had the correct designations been made. Accommodations between \$2,000 and \$25,000 were approved by the Vice-President of Market Operations. Accommodations greater than \$25,000 were approved by the Chief Financial Officer.

78. Many of the accommodation payments were documented by CBOE’s Finance Department in “Non-Standard Transaction” memos. The memos disclosed that CBOE had made at least \$1.6 million in accommodation payments. Examples of these accommodation payments include the following:



- a. A \$240,000 payment to a member firm because it had placed orders with CBOE and then, without canceling them, proceeded to fill the orders at other exchanges;
- b. A \$100,000 rebate as a “one time show of good faith” to a member firm because of an issue with the member firm’s back-office systems which forced it to send orders as a non-member, resulting in higher transaction fees; and
- c. A \$43,496 payment to the same member firm that was subject to the Reg. SHO investigation above that had sent orders, on behalf of one of its affiliates, to CBOE’s Automated Improvement Mechanism, a price improvement auction offered by the Exchange. The payment reimbursed the member firm for the difference between the higher transaction fees it paid as a broker-dealer and the transaction fees paid for member firm proprietary orders.

79. CBOE had no rules in place governing these accommodation payments and, as a result, the payments were not offered to all member firms.

#### *Spread Order Accommodation Payments*

80. In 2001, a member firm wanted to use CBOE’s software that allowed spread orders to be sent electronically for paired execution, but would only do so if it was guaranteed the National Best Bid and Offer (“NBBO”) for both legs of the trade. Although there was no rule that required the NBBO for each leg of a spread trade, the member firm was able to secure NBBO agreements with several designated primary market makers.

81. In 2006, the member firm closed down its presence on CBOE floor. By this time, many of the designated primary market makers had also changed. At the firm’s request, CBOE assumed the agreements and continued to guarantee NBBO on both legs of spread trades.

82. Once CBOE began assisting the firm, CBOE would ensure the NBBO by executing a trade at the NBBO with the member firm in CBOE’s error account whenever there was a non-NBBO fill. CBOE would essentially buy the option from the member firm at the old (non-NBBO) price and resell it to the member firm at the new (NBBO) price.

83. The original non-NBBO transaction was reported on the consolidated tape. The error account trade, however, was not reflected on the tape. CBOE had no rules in place permitting the activity.

#### **Implementing Trading Functions and Features Without Appropriate Rules**

84. On several other occasions, CBOE and C2 changed or implemented new exchange functionality without first obtaining approval, or effectiveness, of a proposed rule change. For example:

- a. CBOE activated percentage distance price check parameters on July 28, 2006 and C2 activated similar parameters on July 25, 2011. However, the exchanges did not submit proposed rule change filings that would authorize the new functionality until August 26, 2011.
- b. C2 operated a quote risk monitor mechanism<sup>12</sup> without a rule since it began operations as a national securities exchange in October 2010. C2 did not file a proposed rule change that would authorize the quote risk monitor mechanism until November 7, 2011.
- c. On February 16, 2009 and July 25, 2011, CBOE and C2, respectively activated auction features which automatically auctioned marketable complex orders that were a specified number of ticks away from the current market. However, the Exchanges did not file proposed rule changes that would authorize this feature until December 6, 2011.

85. In addition, on a number of occasions, CBSX, allowed persons not authorized by rule to submit and execute orders on its exchange, including orders (i) conducted by a terminated member, (ii) where no authorized member could be identified, (iii) conducted by CBOE members who were not authorized to trade on CBSX, and (iv) by an unauthorized sponsored user.

86. CBSX employees also traded directly on the CBSX to resolve positions in the error accounts. This trading was done with no rule in place and little oversight.<sup>13</sup>

### **Failure to Maintain Books and Records**

87. Section 17(a)(1) of the Exchange Act requires every exchange to make and keep for prescribed periods, and to furnish the Commission with a copy of, such records as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or in furtherance of the purposes of the Exchange Act. Rule 17a-1(a) requires exchanges to keep and preserve at least one copy of all documents, including all correspondence, memoranda, papers, books, notices, accounts, and other such records as shall be made or received by it in the course of its business as such and in the conduct of its self-regulatory activity. Rule 17a-1(c) requires exchanges to promptly furnish these records to the Commission upon request. The requirement that exchanges keep and furnish records to the Commission includes the requirement that any accompanying explanation of those records be complete and accurate.<sup>14</sup>

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<sup>12</sup> A quote risk monitor mechanism allows market makers to establish parameters in the system to cancel their electronic quotes in all series of an option class until the market maker refreshes those electronic quotes.

<sup>13</sup> After Commission staff began its investigation of CBOE, CBOE and, where applicable, CBSX, discontinued these practices, self-reported them, and hired outside counsel to further investigate these activities.

<sup>14</sup> *In the Matter of American Stock Exchange LLC*, Exchange Act Release No. 55507, 2007 WL 858743, at \*10 (Mar. 22, 2007).

88. As discussed above, on several occasions CBOE failed to promptly provide documents and records requested by Commission staff that the Exchange made or received in the course of its business or provided such documents and records that were inaccurate, inconsistent, or unreliable.

## **VIOLATIONS**

### **Section 19(g)(1) of the Exchange Act**

89. Section 19(g)(1) of the Exchange Act requires every exchange to comply with the provisions of the Exchange Act, the rules and regulations, thereunder, and its own rules, and to enforce compliance by its members with such provisions, absent some “reasonable justification or excuse” for failing to do so. An exchange’s obligation to enforce compliance under Section 19(g)(1) “necessarily includes an obligation to monitor and maintain surveillance over its members.”<sup>15</sup> An exchange violates Section 19(g)(1) when it fails “to be vigilant in surveilling for, evaluating, and effectively addressing issues that could involve violations” of Commission rules and its own rules.<sup>16</sup>

90. CBOE violated Exchange Act Section 19(g)(1) when it failed to enforce Reg. SHO Rule 204/204T by not adequately investigating Reg. SHO violations; by not adequately detecting, investigating and disciplining Reg. SHO violations through its surveillance program; and by interfering with Commission staff’s investigation of Reg. SHO. In addition, CBOE failed to enforce its firm quote and priority rules by not adequately detecting, investigating and disciplining rule violations. CBOE also failed to enforce its registration rules when it granted a substantial number of waivers without adequately considering whether the circumstances under which the waivers were granted met the standard in its rule that permitted it to grant waivers only in exceptional circumstances and where good cause was shown, from qualifying examinations for persons associated with proprietary trading firms that were CBOE members. Lastly, CBOE was unable to adequately surveil CBSX because CBOE did not maintain a reliable and accurate audit trail of orders submitted by CBSX members to that exchange.

### **Section 19(b)(1) of the Exchange Act**

91. Section 19(b)(1) of the Exchange Act requires every exchange to file any proposed rule change with the Commission and for the Commission to publish notice of the proposed rule change and to give interested persons an opportunity to submit written data, views, and arguments concerning the proposed rule change. Section 19(b)(1) further provides that “[n]o

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<sup>15</sup> *In the Matter of Chicago Stock Exchange, Inc.*, Exchange Act Release No. 48566, 2003 WL 22245922, at \*8 (Sept. 30, 2003) (settled matter) (quoting *In the Matter of Boston Stock Exchange, Inc.*, Exchange Act Release No. 17183, 1980 WL 25454, at \*3 (Oct. 1, 1980)). See also *In the Matter of New York Stock Exchange, Inc.*, Exchange Act Release No. 41574, 1999 WL 430863, at \*1 (June 29, 1999) (settled matter); *In the Matter of National Ass’n of Securities Dealers, Inc.*, Exchange Act Release No. 37538, 1996 WL 447193, at \*2 (Aug. 8, 1996) (settled matter).

<sup>16</sup> *Chicago Stock Exchange*, 2003 WL 22245922, at \*8 (quoting *National Ass’n of Securities Dealers*, 1996 WL 447193, at \*2).

proposed rule change shall take effect unless approved by the Commission or otherwise permitted in accordance with the provisions of this subsection.”

92. CBOE violated Exchange Act Section 19(b)(1) by not filing proposed rule changes governing the use of error accounts and the several accommodation payments and credits provided to certain member firms. Further, CBOE and C2 violated Exchange Act Section 19(b)(1) when they failed to file proposed rule changes until after, and in some cases years after, they had implemented certain trading functions.

### **Section 17(a) of the Exchange Act and Rule 17a-1, Thereunder**

93. Section 17(a)(1) of the Exchange Act requires every exchange to make and keep for prescribed periods, and to furnish the Commission with a copy of, such records as the Commission prescribes, by rule, as necessary or appropriate in the public interest, for the protection of investors, or in furtherance of the purposes of the Exchange Act. Rule 17a-1 requires exchanges to:

keep and preserve at least one copy of all documents, including all correspondence, memoranda, papers, books, notices, accounts, and other such records as shall be made or received by it in the course of its business as such and in the conduct of its self-regulatory activity.

Rule 17a-1(c) requires an exchange promptly to furnish the Commission with a copy of any such document that a representative of the Commission requests. “The requirement that an exchange keep and furnish records to the Commission includes the requirement that any accompanying explanation of those records be complete and accurate and that those materials be furnished on a timely basis.” *In the Matter of American Stock Exchange LLC*, Exchange Act Release No. 55507, 2007 WL 858743, at \*10 (Mar. 22, 2007). Furthermore, the “preparation, maintenance, and furnishing of complete and accurate records are essential to the proper functioning of an exchange as a self-regulatory organization.” *Id.*

94. CBOE violated Section 17(a) of the Exchange Act and Rule 17a-1 thereunder when it: (1) failed to promptly furnish the Commission’s Enforcement Division staff with Reg. SHO surveillance records and provided Enforcement Division staff with information that was not accurate concerning its communications with Trading and Markets during its Reg. SHO investigation; (2) failed to promptly furnish Commission staff with complete and accurate records concerning its surveillance logic for its firm quote and priority rule automated surveillance programs for manually handled orders and trades; (3) failed to promptly furnish Commission staff with complete and accurate records relating to examination waivers for persons associated with proprietary trading member firms; and (4) provided an explanation of the records related to examination waivers for persons associated with proprietary trading member firms that was not complete and accurate.

## **REMEDIAL EFFORTS**

95. After Commission staff brought these matters to the attention of the Regulatory Oversight and Compliance Committee (“ROCC”) of CBOE’s Board of Directors, CBOE and C2 engaged in remedial efforts. In determining to accept the Offer and to establish the penalty amount ordered, the Commission considered CBOE’s and C2’s cooperation and the remedial efforts promptly undertaken by them, including the following:

- a. Implementing a mandatory annual training program for all staff responsible for surveillance, investigation, examination and discipline. The training program, provided over the course of a year, covers the rules for which the staff member is responsible and obligations regarding recordkeeping and confidentiality of information. CBOE has appointed a Training Coordinator in the Regulatory Services Division and hired supporting staff to facilitate and implement the training program. CBOE has also established a baseline training program for each regulatory staff member which will be monitored and recorded for supervisor review;
- b. Providing mandatory formal training to its entire staff and management concerning regulatory independence, on the rules and obligations applicable to SROs, compliance with the federal securities laws and regulations and CBOE/C2 rules, conflicts of interest, recordkeeping, and confidentiality of information;
- c. Assigning subject matter experts in the following areas: Reg. SHO, Net Capital, Customer Protection, Sections 9, 10, 11 and 11A of the Exchange Act, and Rule 15c3-5;
- d. Updating and formalizing CBOE’s written policies regarding regulatory independence and confidentiality of regulatory information;
- e. Implementing a formal written policy prohibiting: (1) the use of any exchange error account pending formal rule authority and filing a rule change concerning CBOE, C2, and CBSX’s use of error accounts; (2) payments to any trading permit holder in connection with trading on CBOE, C2, or CBSX that is not made pursuant to an exchange rule; and (3) any action that has the effect of changing the amount or kind of fee paid by trading permit or privilege holders under the applicable fee schedules for CBOE, C2, or CBSX;
- f. Amending CBOE’s and C2’s rule filing policy to require that CBOE and C2 staff shall consult with their Legal Divisions prior to offering services and products to trading permit holders and other market participants to determine whether a rule change is necessary and to comply with the requirements of the Exchange Act, including that their rules are not designed to permit unfair discrimination among its trading permit holders and other market participants;

- g. Expanding the charter of the ROCC to incorporate compliance with CBOE's obligations as an SRO, and the charter of the Audit Committee to include oversight of the compliance function and an expansion of its enterprise risk management oversight;
- h. Hiring a Chief Compliance Officer ("CCO") whose responsibilities include establishing written policies and procedures reasonably designed to ensure that CBOE fulfills its compliance obligations;
- i. Hiring two Deputy Chief Regulatory Officers and reorganizing the structure of the Regulatory Services Division to enhance the independence of CBOE's regulatory staff and to provide that regulatory staff continue to have sole discretion as to what matters to investigate and prosecute, and is generally insulated from the commercial interests of CBOE/C2 and their members;
- j. Increasing CBOE's regulatory budget by 52.8% over 2011 for 2012 and an additional 46.6% over 2012 for 2013 and increased the headcount of the Regulatory Services Division from 99 approved positions in October 2011 to 169 approved positions by April 2013; and
- k. Engaging a third-party consultant in October 2011 to review CBOE's Reg. SHO surveillances, practices and procedures, and training to determine if any changes were necessary to strengthen CBOE's Reg. SHO enforcement program and procedures.

### **INITIATIVES**

96. CBOE's remedial efforts also include the following initiatives:
- a. Engaging outside counsel to conduct an independent, "bottom-up" review of the Regulatory Services Division focused on regulatory independence. CBOE is in the process of implementing all of outside counsel's recommendations;
  - b. Requesting a third-party consultant to conduct a "gap" analysis to determine whether there are any CBOE or Commission rules that the Exchange's surveillance and examination programs do not adequately cover. Nineteen areas were identified by the consultant that required improvement. CBOE is in the process of implementing all of the consultant's recommendations.
  - c. Engaging a third-party consultant to conduct a comprehensive review of all of its eighty-five (85) non-Reg. SHO regulatory surveillances. The consultant has completed its review and CBOE is in the process of implementing all of the consultant's recommendations;

- d. Engaging a third-party consultant to assess whether identified CBOE action plans reasonably address the consultant's recommendations and to monitor CBOE's progress in completing those action plans; and
- e. Retaining a third-party consultant to conduct a review of CBOE's enterprise risk management framework and recommend areas of improvement. The consultant has completed its review and CBOE is in the process of implementing enhanced risk management procedures and programs.

97. In determining to accept the Offer, the Commission has considered the remedial efforts and voluntary initiatives undertaken by CBOE and determined that under these circumstances it is not in the public interest to impose limitations upon the activities, functions, or operations of CBOE pursuant to Section 19(h)(1) of the Exchange Act.

### **UNDERTAKINGS**

Respondents have undertaken to do the following:<sup>17</sup>

- A. CBOE and C2 shall provide for the autonomy and independence of the regulatory function of CBOE such that the regulatory staff, and any successor thereto, has sole discretion as to what matters to examine, investigate and prosecute, and all decisions regarding resolution of any examination, investigation or prosecution shall be made without regard to the actual or perceived business interests of CBOE, C2, CBSX or any of their trading permit or privilege holders.
- B. CBOE and C2 shall take all necessary steps to ensure that CBOE's/C2's regulatory functions shall be independent from the commercial interests of CBOE/C2 and CBOE's/C2's trading permit holders, including the following:
  - 1. Develop and implement a written regulatory independence policy.
  - 2. Develop and implement a written policy on the confidentiality of regulatory information.
  - 3. Provide annual training on self-regulatory organizations rules and obligations, compliance with the federal securities laws and regulations and CBOE/C2 rules, conflicts of interest, recordkeeping, and confidentiality of information to all CBOE/C2 officers and employees.
  - 4. CBOE shall not permit its Chief Executive Officer to have any direct supervisory responsibility over the CRO, including decisions regarding what matters to examine, investigate and prosecute or other regulatory policy matters. Subject to this limitation and provided that the principle and mandate

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<sup>17</sup> As part of its remediation efforts, CBOE has begun or completed Undertakings A, B, C, D, E, F, G, L, N, P, Q, R, T, and U.

of Undertakings A and B are observed, the CEO may perform all duties and functions customary to that position, including those steps necessary to prepare the certifications called for under this Order.

5. To the extent that the CEO has any indirect supervisory responsibility for the role or function of the CRO, including but not limited to, implementation of the budget for the regulatory function or regulatory personnel matters, the ROCC shall take all steps reasonably necessary to ensure that the CEO does not compromise the regulatory autonomy and independence of the CRO or the regulatory function.
- C. CBOE shall conduct a “bottom-up” review to assess the impact that CBOE’s commercial interests and the interests of its trading permit holders have on CBOE’s regulatory functions no later than 90 days after the issuance of this Order and create a written summary of findings and recommendations.
1. CBOE, under the oversight of the ROCC, shall develop and implement a written plan of corrective actions to address any findings and recommendations, including a date by which each corrective action shall be implemented.
  2. CBOE will provide the written summary of findings and recommendations and its plan of action to the Directors of OCIE and Trading and Markets no later than 180 days from the issuance of this Order.
- D. CBOE and C2 shall implement a mandatory annual training program for all staff responsible for surveillance, investigation, examination, and discipline. The training shall include information on the rules for which the staff member is responsible, recordkeeping, and confidentiality of information.
- E. CBOE shall, no later than 180 days from the issuance of this Order, conduct a gap analysis to determine (i) if there are any CBOE rules or federal laws or regulations for which CBOE does not have an adequate regulatory program, including, if applicable, a reasonable surveillance system; (ii) if CBOE’s existing regulatory program is reasonably capable of detecting violations; (iii) if CBOE’s written regulatory policies and procedures are effective; and (iv) if CBOE is following its written policies and procedures.
1. CBOE shall create a written summary of findings and recommendations.
  2. CBOE, under the oversight of the ROCC, shall develop and implement a plan of corrective action to address any findings and recommendations, including a date by which each corrective action shall be implemented.



3. CBOE will provide the written summary of findings and recommendations and its plan of action to the Directors of OCIE and Trading and Markets no later than 210 days from the issuance of this Order.
- F. CBOE shall, no later than 90 days from the issuance of this Order, review CBOE's Reg. SHO surveillances, practices and procedures, and training to determine if any changes are necessary to strengthen the ability of CBOE to enforce Reg. SHO compliance and create a written summary of findings and recommendations.
1. CBOE, under the oversight of the ROCC, shall develop and implement a plan of corrective action to address any findings and recommendations, including a date by which each corrective action shall be implemented.
  2. CBOE will provide the written summary of findings and recommendations and its plan of action to the Directors of OCIE and Trading and Markets no later than 120 days from the issuance of this Order.
- G. CBOE shall, no later than 120 days from the issuance of this Order, review CBOE's regulatory program, practices and procedures, and training related to firm quote and priority surveillances to determine if any changes are necessary to strengthen the ability of CBOE to enforce these rules and create a written summary of findings and recommendations.
1. CBOE, under the oversight of the ROCC, shall develop and implement a plan of corrective action to address any findings and recommendations, including a date by which each corrective action shall be implemented.
  2. CBOE will provide the written summary of findings and recommendations and its plan of action to the Directors of OCIE and Trading and Markets no later than 150 days from the issuance of this Order.
- H. No later than 60 days after the end of the calendar year for each of the next five years, CBOE shall provide the Director of OCIE with a list of all surveillances with the number of formal investigations opened and the number of disciplinary actions that resulted from these surveillances.
- I. CBOE and C2 shall, no later than 360 days from the issuance of this Order, conduct an analysis of their business operations, based on reasonable inquiry, to determine if CBOE or C2 needs to file any additional rules with the Commission or modify any existing rules and create a written summary of findings and recommendations.
1. If CBOE or C2 identifies any rule that needs to be filed with the Commission or identifies the need to modify an existing rule, CBOE or C2 shall immediately notify the Directors of Trading and Markets and OCIE and provide a plan for ensuring that CBOE or C2 is in prompt compliance with its obligations under the federal securities laws and regulations.

2. Every 120 days from the issuance of this Order until completion of the analysis, CBOE and C2, under the oversight of the Audit Committee, shall provide the Directors of Trading and Markets and OCIE with a status report showing the actions taken to date to comply with this Undertaking and the actions to be taken during the next 120 day period.
  3. Upon completion of the analysis, CBOE and C2, under the oversight of the Audit Committee, shall develop and implement a plan of corrective action to address any findings and recommendations, including a date by which each corrective action shall be implemented.
  4. CBOE and C2 will provide the written summary of findings and recommendations and their plan of action to the Directors of OCIE and Trading and Markets no later than 390 days from the issuance of this Order.
- J. CBOE shall, no later than 150 days from the issuance of this Order, formulate and implement procedures and training designed to ensure that, where CBOE's activities require rule authority, rules are put in place prior to such activity commencing.
- K. If, within 120 days of receipt of any of the written summaries of findings and recommendations and plans of action to be completed pursuant to Undertakings C, E, F, G, and I above, the Directors of Trading and Markets and OCIE determine, based on good cause shown, and notify CBOE or C2 in writing, that the analyses or reviews to be performed pursuant to those Undertakings are inadequate, CBOE or C2 shall retain at its expense an independent consultant, not unacceptable to Commission staff, or request that the previously retained consultant expand the scope of its review (collectively, the "Consultants") to conduct the required analysis or review. The analysis or review by the independent Consultant(s) will be completed no later than 180 days after CBOE or C2 has been notified by the Directors of Trading and Markets and OCIE that the initial analysis or review was inadequate.
1. CBOE or C2, as appropriate, shall provide the Directors of Trading and Markets and OCIE with a written report of the independent consultant's findings no later than 210 days after CBOE or C2 was notified by the Directors of Trading and Markets and OCIE that the initial analysis or review was inadequate.
  2. CBOE or C2, as appropriate, shall develop and implement a plan of corrective action to address any findings, including a date by which each corrective action shall be implemented and provide the plan to the Directors of Trading and Markets and OCIE no later than 240 days from the date that CBOE or C2 was notified by the Directors of Trading and Markets and OCIE that the initial analysis or review was inadequate.

3. CBOE or C2, as appropriate, shall require any independent Consultant retained to satisfy this Undertaking to enter into a written agreement that provides that for the period of engagement and for a period of two (2) years from completion of the engagement, the independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with CBOE, C2, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The written agreement will also provide that the independent Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the independent Consultant in performance of his/her duties under the attached Order shall not, without prior written consent of the Commission staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with CBOE, C2, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.
- L. CBOE shall implement a mandatory annual training program for all officers and employees involved in business development, accounting, and proposed rule change filings covering customer accommodations and the rules related to monies paid by or to trading permit holders.
  - M. CBOE, under the oversight of the ROCC, shall take all reasonably necessary steps to ensure that going forward (a) all Trading Permit Holders, and their associated persons, comply with CBOE Rule 3.6A and all applicable Exchange rules regarding registration, qualification, and continuing education; and (b) examination waivers granted are, in accordance with CBOE Rule 3.6A, given only in exceptional circumstances where good cause is shown.
    1. CBOE shall provide to the Director of Trading and Markets, on a quarterly basis, for a period of two years, a detailed report containing an explanation and justification for each waiver that was granted or denied during that quarter pursuant to CBOE Rule 3.6A. As part of the quarterly report, CBOE shall certify in writing that such waivers comply with CBOE Rule 3.6A.
    2. No later than 180 days from the issuance of this Order, CBOE shall adopt policies, procedures, and internal controls reasonably designed to ensure compliance with CBOE Rule 3.6A.
  - N. CBOE shall, no later than 45 days from the issuance of this Order, implement written policies and procedures designed to prevent unauthorized access to CBSX.
  - O. No later than 120 days after the issuance of this Order, CBOE shall enhance its regulation of CBSX-only trading permit holders by developing and implementing a regulatory plan to enforce all applicable federal securities laws and regulations and CBSX rules, including but not limited to the anti-fraud rules, regardless of trading

- venue. CBOE shall provide a written report of the action it has taken to the Directors of OCIE and Trading and Markets no later than 150 days from the issuance of this Order.
- P. CBOE shall implement an audit trail sufficient to enable CBOE to reconstruct CBSX's market promptly, to effectively surveil CBSX, and to facilitate the effective enforcement of the federal securities laws and regulations and CBSX rules.
- Q. CBOE shall conduct an enterprise risk management review to enhance internal risk management and compliance processes.
- R. CBOE shall employ a CCO whose responsibilities include implementing written policies and procedures reasonably designed to ensure that CBOE fulfills its compliance obligations.
- S. CBOE and C2 shall expend sufficient funds to discharge the Undertakings referenced herein, including, but not limited to, the hiring of sufficient qualified personnel and providing adequate funds for the retention of outside counsel and/or professionals.
- T. CBOE shall provide for the independence of the internal audit department to ensure that it is capable of assessing the effectiveness of controls to review and detect risks within CBOE.
- U. CBOE shall require its internal audit department to develop a 3-year risk-based audit plan for the Regulatory Division. CBOE shall ensure the internal audit department has sufficient resources to implement the 3-year audit plan.
- V. CBOE shall require its CEO to certify, in writing, that CBOE has complied with Undertakings A, B, C, I, J, L, M, N, Q, R, S, T, and U set forth above. The certification shall identify the Undertakings, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. Commission staff may make reasonable requests for further evidence of compliance, and Respondents agree to provide such evidence. The certification and supporting material as to each Undertaking other than Undertaking I shall be submitted to Deborah A. Tarasevich, Assistant Director, with a copy to the Office of Chief Counsel, of the Commission's Enforcement Division, no later than sixty (60) days from the date of the completion of each of the Undertakings, and in any event no later than 240 days from the issuance of this Order. A separate certification with respect to Undertaking I shall be submitted in accordance with the preceding requirement no later than 60 days from the date of the completion of that Undertaking, and in any event no later than 420 days from the issuance of this Order.
- W. CBOE shall require its CRO to certify, in writing, that CBOE has complied with Undertakings A, B, C, D, E, F, G, H, O, P, and S set forth above. The certification shall identify the Undertakings, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance.

Commission staff may make reasonable requests for further evidence of compliance, and Respondents agree to provide such evidence. The certification and supporting material shall be submitted to Deborah A. Tarasevich, Assistant Director, with a copy to the Office of Chief Counsel, of the Commission's Enforcement Division, no later than sixty (60) days from the date of the completion of each of the Undertakings, and in any event no later than 240 days from the issuance of this Order.

X. Beginning one (1) year after the date of the last certification described in Undertaking V above (other than the certification with respect to Undertaking I), and each year thereafter for four (4) years (for a total of five (5) annual certifications), CBOE shall require its CEO to certify to the Director of OCIE and to the Director of Trading and Markets that:

1. CBOE's policies, procedures, and internal controls are reasonably designed to ensure the independence of CBOE's regulatory functions from the commercial interests of CBOE and its trading permit holders and that CBOE is in compliance with those written policies and procedures;
2. CBOE's policies, procedures, and internal controls are reasonably designed to ensure CBOE is filing all new rules and modification to rules in compliance with the Exchange Act; and that CBOE is in compliance with those written policies and procedures;
3. CBOE's policies, procedures, and internal controls are reasonably designed to ensure that payments and/or credits are made to trading permit holders only when allowable under a rule and in a nondiscriminatory manner; and that CBOE is in compliance with those written policies and procedures;
4. CBOE's trading permit holder registration process policies, procedures, and internal controls are reasonably designed to ensure that (i) trading permit holders and their associated persons who are engaged in the securities business register with the Exchange; (ii) waivers are granted only pursuant to and in accordance with CBOE Rule 3.6A; and (iii) CBOE is in compliance with those written policies and procedures; and
5. CBOE's internal controls are reasonably designed to detect and control risks within CBOE, including but not limited to, risks associated with the independence of the Regulatory function, and the filing of all appropriate rules.

Y. Beginning one (1) year after the date of the certification described in Undertaking W above, and each year thereafter for four (4) years (for a total of five (5) annual certifications), CBOE shall require its CRO to certify to the Director of OCIE and to the Director of Trading and Markets that:

1. CBOE's policies, procedures, and internal controls are reasonably designed to ensure the independence of CBOE's regulatory functions from the commercial interests of CBOE and its trading permit holders and that CBOE is in compliance with those written policies and procedures; and
  2. CBOE's surveillance, examination, investigation and disciplinary programs policies and procedures, including but not limited to surveillance parameters and examination and surveillance procedures, are reasonably designed to ensure compliance with and to detect and deter violations of all federal securities laws and Exchange rules; and that CBOE is in compliance with those written policies and procedures.
- Z. C2 shall require its CEO to certify, in writing, that C2 has complied with Undertakings A, B, I, and S set forth above. The certification shall identify the Undertakings, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. Commission staff may make reasonable requests for further evidence of compliance, and Respondents agree to provide such evidence. The certification and supporting material as to each Undertaking other than Undertaking I shall be submitted to Deborah A. Tarasevich, Assistant Director, with a copy to the Office of Chief Counsel, of the Commission's Enforcement Division, no later than sixty (60) days from the date of the completion of each of the Undertakings, and in any event no later than 240 days from the issuance of this Order. A separate certification with respect to Undertaking I shall be submitted in accordance with the preceding requirement no later than 60 days from the date of the completion of that Undertaking, and in any event no later than 420 days from the issuance of this Order.
- AA. C2 shall require its CRO to certify, in writing, that C2 has complied with Undertakings A, B, D and S set forth above. The certification shall identify the Undertakings, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. Commission staff may make reasonable requests for further evidence of compliance, and Respondents agree to provide such evidence. The certification and supporting material shall be submitted to Deborah A. Tarasevich, Assistant Director, with a copy to the Office of Chief Counsel, of the Commission's Enforcement Division, no later than sixty (60) days from the date of the completion of each of the Undertakings, and in any event no later than 240 days from the issuance of this Order.
- BB. Beginning one (1) year after the date of the last certification described in Undertaking Z above (other than the certification with respect to Undertaking I), and each year thereafter for four (4) years (for a total of five (5) annual certifications), C2 shall require its CEO to certify to the Director of OCIE and to the Director of Trading and Markets that:
1. C2's policies, procedures, and internal controls are reasonably designed to ensure the independence of C2's regulatory functions from the commercial

interests of C2 and its trading permit holders and that C2 is in compliance with those written policies and procedures; and

2. C2's policies, procedures, and internal controls are reasonably designed to ensure C2 is filing all new rules and modification to rules in compliance with the Exchange Act; and that C2 is in compliance with those written policies and procedures.
- CC. Beginning one (1) year after the date of the certification described in Undertaking AA above, and each year thereafter for four (4) years (for a total of five (5) annual certifications), C2 shall require its CRO to certify to the Director of OCIE and to the Director of Trading and Markets that C2's policies, procedures, and internal controls are reasonably designed to ensure the independence of C2's regulatory functions from the commercial interests of C2 and its trading permit holders and that C2 is in compliance with those written policies and procedures.
- DD. The Directors of Trading and Markets and OCIE, or their designees, may, based on good cause shown by CBOE or C2, jointly grant in writing: (1) extensions of time for compliance with any of the foregoing undertakings; and (2) modifications to any of the foregoing undertakings in connection with a filing made by CBOE or C2 under the Exchange Act and the rules thereunder that is approved by the Commission, including by delegated authority. Nothing herein would preclude CBOE or C2 from applying to the Commission for other modifications to the foregoing undertakings.

#### IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondents' Offers.

Accordingly, pursuant to Sections 19(h)(1) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent CBOE cease and desist from committing or causing any violations and any future violations of Sections 17(a)(1), 19(b)(1), and 19(g)(1) of the Exchange Act and Rule 17a-1, thereunder.

B. Pursuant to Section 21C of the Exchange Act, Respondent C2 cease and desist from committing or causing any violations and any future violations of Section 19(b)(1) of the Exchange Act.

C. Pursuant to Section 19(h)(1) of the Exchange Act, Respondents CBOE and C2 are censured.

D. Pursuant to Section 21B(a)(2) of the Exchange Act, Respondent CBOE shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of \$6,000,000 (\$6 million) to the United States Treasury. If timely payment is not made, additional

interest shall accrue pursuant to 31 U.S.C. § 3717. Such payment must be made in one of the following ways: (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) Respondent may make direct payment from a bank account via Pay.gov through the Commission's website at <http://www.sec.gov/about/offices/ofm.htm>; or (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center  
Accounts Receivable Branch  
HQ Bldg., Room 181, AMZ-341  
6500 South MacArthur Boulevard  
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying CBOE as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Daniel M. Hawke, Chief, Market Abuse Unit, Division of Enforcement, Securities and Exchange Commission, The Mellon Independence Center, 701 Market Street, Philadelphia, PA 19106-1532.

E. Respondents shall comply with the Undertakings enumerated above.

By the Commission.

Elizabeth M. Murphy  
Secretary