

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-67596; File No. SR-C2-2012-023)

August 6, 2012

Self-Regulatory Organizations; C2 Options Exchange, Incorporated; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to the Options Regulatory Fee

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on July 31, 2012, C2 Options Exchange, Incorporated (the “Exchange” or “C2”) filed with the Securities and Exchange Commission (the “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to institute a new transaction-based “Options Regulatory Fee”.

The text of the proposed rule change is available on the Exchange’s website

(<http://www.c2exchange.com/Legal/>), at the Exchange’s Office of the Secretary, and at the

Commission’s Public Reference Room.

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

A. Self-Regulatory Organization's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rule Change

1. Purpose

In order to offset more fully the cost of the Exchange's regulatory programs, the Exchange proposes to adopt a transaction-based Options Regulatory Fee ("ORF") of \$0.0015 per contract. The Exchange is adopting an ORF due to substantial increases in resources devoted to regulatory services, including the recent hiring of many new employees, increased office space and regulatory systems enhancements. The proposed fee would be operative on August 1, 2012.

The ORF would be assessed by the Exchange to each Permit Holder for all options transactions executed or cleared by the Permit Holder that are cleared by The Options Clearing Corporation ("OCC") in the customer range, i.e., transactions that clear in a customer account at OCC, regardless of the marketplace of execution. In other words, the Exchange would impose the ORF on all customer-range transactions executed by a Permit Holder, even if the transactions do not take place on the Exchange.<sup>3</sup> The ORF would also be charged for transactions that are not executed by a Permit Holder but are ultimately cleared by a Permit Holder. In the case where a Permit Holder executes a transaction and a Permit Holder clears the transaction, the ORF would be assessed to the Permit Holder who executed the transaction. In the case where a non-Permit Holder executes a transaction and a Permit Holder clears the transaction, the ORF would be assessed to the Permit Holder who clears the transaction. The Exchange believes that its broad regulatory responsibilities with respect to Permit Holders' activities supports applying the ORF

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<sup>3</sup> Exchange rules require each Permit Holder to record the appropriate account origin code on all orders at the time of entry in order to allow the Exchange to properly prioritize and route orders and assess transaction fees pursuant to the rules of the Exchange and report resulting transactions to the OCC. C2 order origin codes are defined in C2 Regulatory Circular RG10-4. The Exchange represents that it has surveillances in place to verify that Permit Holders mark orders with the correct account origin code.

to transactions cleared but not executed by a Permit Holder. The Exchange's regulatory responsibilities are the same regardless of whether a Permit Holder executes a transaction or clears a transaction executed on its behalf. The Exchange regularly reviews all such activities, including performing surveillance for position limit violations, manipulation, frontrunning, contrary exercise advice violations and insider trading.<sup>4</sup> These activities span across multiple exchanges.

The ORF would be collected indirectly from Permit Holders through their clearing firms by OCC on behalf of the Exchange. The Exchange expects that Permit Holders will pass-through the ORF to their customers in the same manner that firms pass-through to their customers the fees charged by Self Regulatory Organizations (“SROs”) to help the SROs meet their obligations under Section 31 of the Exchange Act.

The ORF is designed to recover a material portion of the costs to the Exchange of the supervision and regulation of Permit Holder customer options business, including performing routine surveillances, investigations, as well as policy, rulemaking, interpretive and enforcement activities. The Exchange believes that revenue generated from the ORF, when combined with all of the Exchange's other regulatory fees, will cover a material portion, but not all, of the

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<sup>4</sup> The Exchange also participates in The Options Regulatory Surveillance Authority (“ORSA”) national market system plan and in doing so shares information and coordinates with other exchanges designed to detect the unlawful use of undisclosed material information in the trading of securities options. ORSA is a national market system comprised of several self-regulatory organizations whose functions and objectives include the joint development, administration, operation and maintenance of systems and facilities utilized in the regulation, surveillance, investigation and detection of the unlawful use of undisclosed material information in the trading of securities options. The Exchange compensates ORSA for the Exchange's portion of the cost to perform insider trading surveillance on behalf of the Exchange. The ORF will cover the costs associated with the Exchange's arrangement with ORSA.

Exchange's regulatory costs.<sup>5</sup> The Exchange notes that its regulatory responsibilities with respect to Permit Holder compliance with options sales practice rules have been allocated to FINRA under a 17d-2 agreement. The ORF is not designed to cover the cost of options sales practice regulation.

The Exchange would monitor the amount of revenue collected from the ORF to ensure that it, in combination with its other regulatory fees and fines, does not exceed the Exchange's total regulatory costs. The Exchange expects to monitor regulatory costs and revenues at a minimum on an annual basis. If the Exchange determines regulatory revenues exceed regulatory costs, the Exchange would adjust the ORF by submitting a fee change filing to the Commission. The Exchange would notify Permit Holders of adjustments to the ORF via regulatory circular.

The Exchange believes the proposed ORF is equitably allocated because it would be charged to all Permit Holders on all their customer options business. The Exchange believes the proposed ORF is reasonable because it will raise revenue related to the amount of customer options business conducted by Permit Holders, and thus the amount of Exchange regulatory services those Permit Holders will require.

As a fully-electronic exchange without a trading floor, the amount of resources required by the Exchange to regulate non-customer trading activity is significantly less than the amount of resources the Exchange must dedicate to regulate customer trading activity. This is because regulating customer trading activity is much more labor intensive and requires greater expenditure of human and technical resources than regulating non-customer trading activity, which tends to be more automated and less labor-intensive. As a result, the costs associated with administering the customer component of the Exchange's overall regulatory program are

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<sup>5</sup> The Exchange collects other regulatory revenues from Firm Designated Examining Authority Fees and Communication Review Fees. See C2 Fees Schedule, Section 8.

materially higher than the costs associated with administering the non-customer component (e.g., Permit Holder proprietary options transactions) of its regulatory program.<sup>6</sup>

The Exchange believes it is reasonable and appropriate for the Exchange to charge the ORF for options transactions regardless of the exchange on which the transactions occur. The Exchange has a statutory obligation to enforce compliance by Permit Holders and their associated persons with the Exchange Act and the Rules of the Exchange and to surveil for other manipulative conduct by market participants (including non-Permit Holders) trading on the Exchange. The Exchange cannot effectively surveil for such conduct without looking at and evaluating activity across all options markets. Many of the Exchange's market surveillance programs require the Exchange to look at and evaluate activity across all options markets, such as surveillance for position limit violations, manipulation, frontrunning and contrary exercise advice violations/expiring exercise declarations.<sup>7</sup> Also, the Exchange and the other options exchanges are required to populate a consolidated options audit trail (“COATS”) system in order to surveil Permit Holder activities across markets.<sup>8</sup>

In addition to its own surveillance programs, the Exchange works with other SROs and exchanges on intermarket surveillance related issues. Through its participation in the

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<sup>6</sup> If the Exchange changes its method of funding regulation or if circumstances otherwise change in the future, the Exchange may decide to impose the ORF or a separate regulatory fee on Permit Holder proprietary options transactions if the Exchange deems it advisable.

<sup>7</sup> The Exchange and other options SROs are parties to a 17d-2 agreement allocating among the SROs regulatory responsibilities relating to compliance by the common members with rules for expiring exercise declarations, position limits, OCC trade adjustments, and Large Option Position Report reviews. See Securities Exchange Act Release No. 63430 (December 3, 2010), 75 FR 76758 (December 9, 2010).

<sup>8</sup> COATS effectively enhances intermarket options surveillance by enabling the options exchanges to reconstruct the market promptly to effectively surveil certain rules.

Intermarket Surveillance Group (“ISG”)<sup>9</sup>, the Exchange shares information and coordinates inquiries and investigations with other exchanges designed to address potential intermarket manipulation and trading abuses. The Exchange's participation in ISG helps it to satisfy the Exchange Act requirement that it have coordinated surveillance with markets on which security futures are traded and markets on which any security underlying security futures are traded to detect manipulation and insider trading.<sup>10</sup>

The Exchange believes that charging the ORF across markets will avoid having Permit Holders direct their trades to other markets in order to avoid the fee and to thereby avoid paying for their fair share of regulation. If the ORF did not apply to activity across markets then Permit Holders would send their orders to the least cost, least regulated exchange. Other exchanges could impose a similar fee on their member's activity, including the activity of those members on C2. In addition to the ORF that is currently in place at other exchanges<sup>11</sup>, the Exchange notes that there is established precedent for an SRO charging a fee across markets, namely, FINRA's Trading Activity Fee.<sup>12</sup> While the Exchange does not have all the same regulatory responsibilities as FINRA, the Exchange believes that, like the other exchanges that assess an ORF, its broad regulatory responsibilities with respect to Permit Holders' activities, irrespective of where their transactions take place, supports a regulatory fee applicable to transactions on

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<sup>9</sup> ISG is an industry organization formed in 1983 to coordinate intermarket surveillance among the SROs by cooperatively sharing regulatory information pursuant to a written agreement between the parties. The goal of the ISG's information sharing is to coordinate regulatory efforts to address potential intermarket trading abuses and manipulations.

<sup>10</sup> See Exchange Act Section 6(h)(3)(I).

<sup>11</sup> The BOX Options Exchange, LLC (“BOX”), Chicago Board Options Exchange, Incorporated (“CBOE”), the International Securities Exchange, LLC (“ISE”), NYSE Arca, Inc. (“NYSEArca”), NYSE MKT LLC (“NYSE MKT”), NASDAQ OMX PHLX, LLC (“Phlx”) and NASDAQ Stock Market, LLC (“NASDAQ”) all charge ORFs.

<sup>12</sup> See Securities Exchange Act Release No. 47946 (May 30, 2003), 68 FR 34021 (June 6, 2003).

other markets. Unlike FINRA's Trading Activity Fee, the ORF would apply only to a Permit Holder's customer options transactions.

## 2. Statutory Basis

The Exchange believes the proposed rule change is consistent with the Securities Exchange Act of 1934 (the “Act”) and the rules and regulations thereunder applicable to the Exchange and, in particular, the requirements of Section 6(b) of the Act.<sup>13</sup> Specifically, the Exchange believes the proposed rule change is consistent with Section 6(b)(4) of the Act<sup>14</sup>, which provides that Exchange rules may provide for the equitable allocation of reasonable dues, fees, and other charges among its Permit Holders and other persons using its facilities.

In particular, the Exchange believes the ORF is equitable and not unfairly discriminatory because it is objectively allocated to Permit Holders in that it would be charged to all Permit Holders on all their transactions that clear as customer at the OCC. Moreover, the Exchange believes the ORF ensures fairness by assessing higher fees to those Permit Holders that require more Exchange regulatory services based on the amount of customer options business they conduct. As a fully-electronic exchange without a trading floor, the amount of resources required by the Exchange to regulate non-customer trading activity is significantly less than the amount of resources the Exchange must dedicate to regulate customer trading activity. This is because regulating customer trading activity is much more labor intensive and requires greater expenditure of human and technical resources than regulating non-customer trading activity, which tends to be more automated and less labor-intensive. As a result, the costs associated with administering the customer component of the Exchange's overall regulatory program are

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<sup>13</sup> 15 U.S.C. 78f(b).

<sup>14</sup> 15 U.S.C. 78f(b)(4).

materially higher than the costs associated with administering the non-customer component (e.g., Permit Holder proprietary options transactions) of its regulatory program.

The ORF seeks to recover the costs of supervising and regulating Permit Holders including performing routine surveillances, investigations, examinations, financial monitoring, and policy, rulemaking, interpretive, and enforcement activities. The Exchange's regulatory responsibilities are the same regardless of whether a Permit Holder executes a transaction or clears a transaction executed on its behalf. The Exchange believes that this proposal is reasonable, equitable and not unfairly discriminatory for the foregoing reasons and also because this proposal would offset more fully the cost of the Exchange's regulatory programs. The Exchange is adopting an ORF due to substantial increases in resources devoted to regulatory services, including the recent hiring of many new employees, increased office space and regulatory systems enhancements.

The Commission has addressed the funding of an SRO's regulatory operations in the Concept Release Concerning Self-Regulation<sup>15</sup> and the release on the Fair Administration and Governance of Self-Regulatory Organizations.<sup>16</sup> In the Concept Release, the Commission states that: "Given the inherent tension between an SRO's role as a business and a regulator, there undoubtedly is a temptation for an SRO to fund the business side of its operations at the expense of regulation".<sup>17</sup> In order to address this potential conflict, the Commission proposed in the Governance Release rules that would require an SRO to direct monies collected from regulatory fees, fines, or penalties exclusively to fund the regulatory operations and other programs of the

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<sup>15</sup> See Securities Exchange Act Release No. 50700 (November 18, 2004), 69 FR 71256 (December 8, 2004) ("Concept Release").

<sup>16</sup> See Securities Exchange Act Release No. 50699 (November 18, 2004), 69 FR 71126 (December 8, 2004) ("Governance Release").

<sup>17</sup> Concept Release at 71268.

SRO related to its regulatory responsibilities.<sup>18</sup> The Exchange has designed the ORF to generate revenues that, when combined with all of the Exchange's other regulatory fees, would recover a material portion, but not all, of C2's regulatory costs, which is consistent with the Commission's view that regulatory fees be used for regulatory purposes and not to support the Exchange's business side.

B. Self-Regulatory Organization's Statement on Burden on Competition

C2 does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The Exchange neither solicited nor received comments on the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change has become effective pursuant to Section 19(b)(3)(A)<sup>19</sup> of the Act and paragraph (f) of Rule 19b-4<sup>20</sup> thereunder. At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

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<sup>18</sup> Governance Release at 71142.

<sup>19</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>20</sup> 17 C.F.R. 240.19b-4(f).

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-C2-2012-023 on the subject line.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-C2-2012-023. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer

to File Number SR-C2-2012-023 and should be submitted by [insert date 21 days from the date of publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>21</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>21</sup> 17 CFR 200.30-3(a)(12).