

SECURITIES AND EXCHANGE COMMISSION
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August 31, 2012

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

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on August 21, 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 and II 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 adopt a Designated Primary Market-Maker (“DPM”) program. 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, at the Commission’s website (<http://www.sec.gov>), 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.

¹ 15 U.S.C. 78s(b)(1).

² 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

The proposed rule change proposes to adopt a DPM program.³ The Exchange believes the DPM program will encourage deeper liquidity in allocated classes by imposing obligations on DPMs to attract order flow to the Exchange in allocated securities and to quote competitively. These proposed Rules also impose special eligibility requirements and market performance standards on DPMs. As specialists, DPMs will receive a trade participation right in their allocated classes in exchange for their heightened responsibilities.

DPM Program

Rule 1.1 – Definition of DPM⁴

The proposed rule change amends Rule 1.1 to adopt a definition of the term “Designated Primary Market-Maker”, which is used throughout the proposed DPM Rules. A DPM is a Participant⁵ organization that is approved by the Exchange to function in allocated securities as a Market-Maker and is subject to obligations under proposed Rule 8.17. The purpose of requiring that a DPM be an organization is to ensure that each DPM has a formal organizational structure in place to govern the manner in which it will operate as a DPM. The Exchange believes it is

³ The proposed rules are based generally on the rules governing the DPM program on Chicago Board Options Exchange, Incorporated (“CBOE”), excluding among other things certain provisions that are inapplicable to C2 (such as provisions related to floor trading and CBOE-specific provisions) as well as other provisions that are outdated. See CBOE Rules 6.45A(a)(ii)(2) and (iii), 6.45B(a)(i)(2) and (iii), 8.80, 8.83 – 8.91, 8.95, and 17.50(g)(14). See Item 8 of the Form 19b-4 for a discussion of the differences between the proposed Rules and the corresponding CBOE rules.

⁴ See CBOE Rule 8.80(a).

⁵ A “Participant” is an Exchange-recognized holder of a Trading Permit, which is an Exchange-issued permit that confers the ability to transact on the Exchange. See Rule 1.1.

essential that it have the sole authority to approve a Participant organization to act as a DPM to ensure that the Participant organization satisfies the eligibility requirements set forth in proposed Rule 8.14 and the financial requirements set forth in proposed Rule 8.18, and can otherwise meet the obligations and responsibilities of a DPM set forth in proposed Rule 8.17.

Rule 8.14 – Approval to Act as a DPM⁶

Proposed Rule 8.14 addresses the DPM approval process. To act as a DPM, a Participant must file an application with the Exchange on such forms as the Exchange may prescribe. The Exchange will determine the appropriate number of approved DPMs. The Exchange will make each DPM approval from among the DPM applications on file with the Exchange, based on the Exchange's judgment as to which applicant is best able to perform the functions of a DPM. The factors the Exchange may consider when making this selection include, but are not limited to, any one or more of the following:

- (1) adequacy of capital;
- (2) operational capacity;
- (3) trading experience of and observance of generally accepted standards of conduct by the applicant and its associated persons;
- (4) regulatory history of and history of adherence to Exchange Rules by the applicant and its associated persons; and
- (5) willingness and ability of the applicant and its associated persons to promote the Exchange as a marketplace.

⁶ See CBOE Rules 8.83, 8.88, and 8.89.

The following are some examples of the many ways in which the Exchange may consider these factors:

- In considering adequacy of capital of an applicant, the Exchange may look at whether the applicant meets the financial requirements set forth in proposed Rule 8.18 and whether it otherwise has the resources to meet the heightened responsibilities.
- In considering operational capacity of an applicant, the Exchange may look to criteria such as the number of Market-Makers or personnel and the ability to process order flow in determining whether it would be able to satisfy the DPM obligations in an efficient manner.
- In considering trading experience of and observance of generally accepted standards of conduct by the applicant and its associated persons, the Exchange may look at the applicant's and its associated persons' history at the Exchange or in the industry, the trading volume of the applicant and its associated persons, and market performance reviews in determining whether the applicant would be able to meet the DPM market performance standards.
- In considering the regulatory history of and history of adherence to Exchange Rules by the applicant and its associated persons, the Exchange may look to whether the applicant or its associated persons have been found to have violated Exchange rules or have been subject to any enforcement proceedings in determining whether the applicant and its associated persons would comply with obligations imposed by the DPM Rules and other Rules of the Exchange, as well as federal securities laws and regulations.
- In considering willingness and ability of the applicant and its associated persons to promote the Exchange as a marketplace, the Exchange may look at whether the

applicant has engaged (or how it intends to engage) in activities such as assisting in meeting and educating market participants, maintaining communications with Participants in order to be responsive to suggestions and complaints, and responding to suggestions and complaints in determining whether the applicant could bring order flow to the Exchange.

These are the primary factors that the Exchange believes are necessary for it to consider when determining whether a DPM applicant is able to meet the DPM obligations, responsibilities, and market performance standards imposed by the proposed DPM Rules. Given that the Exchange may limit the number of approved DPMs, it is important that the Exchange can reasonably determine that the Participants it approves to act as DPMs will increase liquidity and quote competitively in order to attract order flow as intended by the proposed DPM program.

Each applicant for approval as a DPM will have an opportunity to present any matter that it wishes the Exchange to consider in conjunction with the approval decision. The Exchange may require that a presentation be solely or partially in writing, and may require the submission of additional information from the applicant or its associated persons. Formal rules of evidence will not apply to these proceedings. This opportunity will allow a DPM applicant to ensure that the Exchange considers all information that the DPM applicant deems relevant, in addition to the standard information described by the factors above that the Exchange reviews. The Exchange believes the presentation of this information, in addition to the information requested by the Exchange, will result in fair and fully informed decisions by the Exchange during the DPM approval process.

In selecting an applicant for approval as a DPM, the Exchange may place one or more conditions on the approval, including but not limited to conditions concerning the capital or

operations of or persons associated with the DPM applicant, and the number or type of securities that may be allocated to the applicant. Depending on the circumstances surrounding a specific DPM applicant, the Exchange believes it is necessary to have the ability to impose conditions on the specific DPM approval in addition to the obligations otherwise imposed by the DPM Rules as an additional means to ensure that the DPM applicant is able to adequately perform the DPM functions.

Each DPM will retain its approval to act as a DPM for one year, unless the Exchange relieves the DPM of its approval and obligations to act as a DPM or earlier terminates the DPM's approval to act as a DPM pursuant to proposed Rule 8.20. After each one-year term, a DPM may file an application with the Exchange to renew its approval to act as a DPM on forms prescribed by the Exchange, which renewal application the Exchange may approve or disapprove in its sole discretion in the same manner and based on the same factors set forth in proposed Rule 8.14(b) through (d), and any other factors the Exchange deems relevant (including an evaluation of the extent to which the DPM has satisfied its obligations under proposed Rule 8.17). Because the proposed rule change provides that the Exchange will determine the appropriate number of approved DPMs in a class, the Exchange believes that having temporary DPM appointments will provide all Participants with regular opportunities to be selected as DPMs by the Exchange rather than allow certain Participants to have perpetual DPM appointments.

If the Exchange terminates or otherwise limits its approval for a Participant to act as a DPM, the Exchange may do one or both of the following: (1) approve a DPM on an interim basis, pending the final approval of a new DPM; and (2) allocate on an interim basis to another DPM(s) the securities that were allocated to the affected DPM, pending a final allocation of the securities pursuant to proposed Rule 8.15 (as described below). Neither an interim approval nor

allocation will be viewed as a prejudgment with respect to the final approval or allocation. Interim approvals and allocations will provide uninterrupted DPM quoting in appointed classes and prevent any reduced liquidity in those classes that could otherwise result from a termination, condition, or limit on a DPM's approval or allocation.

Proposed Rule 8.14(g) provides that DPM appointments may not be sold, assigned, or otherwise transferred without prior written approval of the Exchange. This provision clarifies that only the Exchange may authorize a firm to act as a DPM, which will allow the Exchange to ensure that a Participant is qualified to adequately perform DPM functions and fulfill its obligations and responsibilities as a DPM under the proposed DPM Rules.

Rule 8.15 – Allocation of Securities to DPMs⁷

Proposed Rule 8.15 sets forth the manner in which the Exchange will allocate securities to DPMs. Proposed Rule 8.15(a) provides that the Exchange will determine for each security traded on the Exchange whether the security should be allocated to a DPM and, if so, to which DPM the security should be allocated. The proposed rule change could produce additional quotation volume in classes that are allocated to DPMs. The Exchange maintains a rigorous capacity planning program that monitors system performance and projected capacity demands and, as a general matter, considers the potential system capacity impact of all new initiatives. The Exchange has analyzed the potential for additional quote traffic resulting from the addition of DPMs and has concluded that the Exchange has sufficient system capacity to handle those additional quotes without degrading the performance of its systems. The Exchange also notes that any additional quote traffic will be limited, as the Exchange may allocate securities to DPMs on a class-by-class basis as opposed to allocating all classes to DPMs. Ultimately, the Exchange

⁷ See CBOE Rule 8.95.

believes that it has the necessary systems capacity to allocate option classes to DPMs as described in this proposed rule change. The Exchange will monitor quoting volume associated with DPMs and its effect on C2's systems.

Proposed Rule 8.15(b) describes the criteria that the Exchange may consider in making allocation determinations. The factors the Exchange may consider when making these determinations include, but are not limited to, any one or more of the following: performance, volume, capacity, market performance commitments, operational factors, efficiency, competitiveness, environment in which the security will be traded, expressed preferences of issuers, and recommendations of any Exchange committees. The following are some examples of the many ways in which these criteria may be applied:

- In considering performance, the Exchange may look at the market performance ranking of the applicable DPMs, as established by market performance reviews that are conducted by the Exchange.
- In considering volume, the Exchange may look at the anticipated trading volume of the security and the trading volume attributable to the applicable DPMs in determining which DPMs would be best able to handle the additional volume.
- In considering capacity, operational factors, and efficiency, the Exchange may look to criteria such as the number of Market-Makers or DPM personnel, the ability to process order flow, and the amount of DPM capital in determining which DPMs would be best able to handle additional securities.
- In considering marketing performance commitments, the Exchange may look at the pledges a DPM has made with respect to how narrow its bid-ask spreads will be and

the number of contracts for which it will honor its disseminated market quotations beyond what is required by Exchange Rules.

- In considering competitiveness, the Exchange may look at percentage of volume attributable to a DPM in allocated securities that are multiply listed.
- In considering the environment in which the security will be traded, the Exchange may seek a proportionate distribution of securities between the Market-Maker system and the DPM system and across different DPMs.
- In considering expressed preferences of issuers, the Exchange may consider the views of the issuer of a security traded on the Exchange with respect to the allocation of that security or to the licensor of an index on which an index option is based with respect to the allocation of that index option.
- The Exchange may consider the recommendation of any Exchange committees, particularly those that evaluate DPM market performance.

Proposed Rule 8.15(c) provides that the Exchange may remove an allocation and reallocate the applicable security during a DPM's term if the DPM fails to adhere to any market performance commitments made by the DPM in connection with receiving the allocation. The Exchange typically requests that DPMs make market performance commitments as part of their applications to receive allocations of particular securities. As described above, these commitments may relate to pledges to keep bid-ask spreads within a particular width or to make disseminated quotes firm for a designated number of contracts beyond what is required by Exchange Rules. Proposed Rule 8.15(c) permits the Exchange to remove an allocation if these commitments are not met, which the Exchange believes will incentive [sic] DPMs to abide by

these commitments. The Exchange believes these types of commitments will be instrumental in causing DPMs to quote more competitively.

Proposed Rule 8.15(c) also provides that the Exchange may change an allocation determination if it concludes that doing so is in the best interests of the Exchange based on operational factors or efficiency. For example, if, due to market conditions, trading volume in a security greatly increased over a very short time frame and the DPM allocated that security could not handle the additional order flow, the Exchange may deem it necessary to reallocate the security to another DPM with the capacity to do so. This provision will allow the Exchange to ensure that there is sufficient liquidity during trading hours in the allocated option classes.

Proposed Rule 8.15(d) provides that prior to taking any action to remove an allocation, the Exchange will generally give the DPM prior notice of the contemplated action and an opportunity to be heard concerning the action. The only exception to this requirement would be in those unusual situations when expeditious action is required due to extreme market volatility or some other situation requiring emergency action. Specifically, except when expeditious action is required, proposed Rule 8.15(d) requires that prior to taking any action to remove an allocation, the Exchange must notify the DPM involved of the reasons the Exchange is considering taking the contemplated action, and will either convene one or more informal meetings with the DPM to discuss the matter, or provide the DPM with the opportunity to submit a written statement to the Exchange concerning the matter. Due to the informal nature of the meetings provided for under proposed Rule 8.15(d) and in order to encourage constructive communication between the Exchange and the affected DPM at those meetings, ordinarily neither counsel for the Exchange nor counsel for the DPM will be invited to attend these meetings and no verbatim record of the meetings will be kept.

As with any decision made by the Exchange, any person adversely affected by a decision made by the Exchange to remove an allocation may appeal the decision to the Exchange under Chapter 19 of the Exchange Rules. The appeal procedures in Chapter 19 provide for the right to a formal hearing concerning any such decision and for the right to be accompanied, represented, and advised by counsel at all stages of the proceeding. In addition, any decision of the Exchange's Appeals Committee may be appealed to the Board of Directors pursuant to CBOE Rule 19.5 (which is incorporated into the Exchange Rules). The Exchange believes these hearing and appeal procedures will provide DPMs with appropriate due process with respect to decisions made regarding their DPM allocations and will promote a fair and fully informed decision-making process.

Proposed Rule 8.15(e) provides that the allocation of a security to a DPM does not convey ownership rights in the allocation or in the order flow associated with the allocation. Proposed Rule 8.15(e) is intended to make clear that DPMs may not buy, sell, or otherwise transfer an allocation and that, instead, the Exchange has the sole authority to determine allocations. As discussed above, DPM appointments may only be transferred with Exchange approval pursuant to proposed Rule 8.14(g).

Proposed Rule 8.15(f) provides that in allocating and reallocating securities to DPMs, the Exchange will act in accordance with any limitation or restriction on the allocation of securities that is established pursuant to another Exchange Rule. For example, the Exchange may take remedial action against a DPM for failure to satisfy minimum market performance standards, and such action may involve a restriction related to the allocation of securities to that DPM. Similarly, the Exchange may place restrictions on a DPM's ability to receive or retain allocations of securities pursuant to various provisions of these proposed Rules, including as a condition of

appointment as a DPM (proposed Rule 8.14(d)), due to failure to perform DPM functions (proposed Rule 8.20(a)(2)), or due to a material financial or operational change (proposed Rule 8.20(a)(1)). Proposed Rule 8.15(f) is intended to make clear that the Exchange must act in accordance with any of these restrictions in making allocation determinations.

Proposed Rule 8.15, Interpretation and Policy .01 generally provides that the Exchange may reallocate a security at the end of a DPM's one-year term, in the event that the security is removed pursuant to another Exchange Rule from the DPM to which the security has been allocated, or in the event that for some other reason the DPM to which the security has been allocated no longer retains the allocation. For example, at the end of a DPM's term, the Exchange may allocate the security to the same DPM again (if the DPM applied for its appointment to be renewed and the Exchange approved the renewal application), to another DPM, or to no DPM. As another example, as described above, the Exchange may take remedial actions against DPMs in specified circumstances, including the removal of an allocation. Proposed Rule 8.15, Interpretation and Policy .01 is intended to clarify that in the event the Exchange removes an allocation pursuant to Exchange Rules, the Exchange will reallocate the security pursuant to proposed Rule 8.15. The only exception to this provision is that the Exchange is authorized pursuant to proposed Rule 8.14(f) to allocate to an interim DPM on a temporary basis a security that is removed from another DPM until the Exchange has made a final allocation of the security. As with several other proposed Rules, this provision is intended allow the Exchange to ensure that there is sufficient liquidity in allocated classes despite changing circumstances.

Rule 8.16 – Conditions on the Allocation of Securities to DPMs⁸

Proposed Rule 8.16 allows the Exchange to establish (1) restrictions applicable to all DPMs on the concentration of securities allocable to a single DPM and to affiliated DPMs and (2) minimum eligibility standards applicable to all DPMs, which must be satisfied in order for a DPM to receive allocations of securities, including but not limited to standards relating to adequacy of capital and operational capacity (including number of personnel). Among the reasons for granting the Exchange the authority to limit the concentration of securities allocable to a single DPM and to affiliated DPMs is to promote competition in the Exchange's market and to help ensure that no DPM or group of affiliated DPMs is allocated such a large number of securities that it would be difficult for the Exchange to quickly reallocate those securities to other DPMs or Market-Makers in the event that for some reason the DPM or group of affiliated DPMs were no longer able to perform in that capacity. Among the reasons for granting the Exchange the authority to establish minimum eligibility standards for DPMs to receive allocations of securities is to help ensure that a DPM has the financial and operational ability to handle additional allocations of securities and meet its DPM obligations with respect to those securities. Similarly, the Exchange may utilize this proposed Rule to establish specific minimum market performance standards that must be satisfied by DPMs in order to receive allocations of securities so that a DPM that is not performing adequately with respect to the securities that have already been allocated to the DPM is not allocated additional securities.

Rule 8.17 – DPM Obligations⁹

Proposed Rule 8.17 describes the obligations of a DPM. Proposed Rule 8.17(a) includes the general obligation with respect to each of its allocated securities to fulfill all of the

⁸ See CBOE Rule 8.84.

⁹ See CBOE Rule 8.85.

obligations of a Market-Maker under Exchange Rules in addition to the requirements set forth in this proposed Rule.¹⁰ Proposed Rule 8.17(a) requires each DPM:

- (1) to provide continuous quotes in at least the lesser of 99% of the non-adjusted option series (as defined in Rule 8.5(a)(1)) or 100% of the non-adjusted option series minus one call-put pair of each option class allocated to it, with the term “call-put pair” referring to one call and one put that cover the same underlying instrument and have the same expiration date and exercise price, and assure that its disseminated market quotations are accurate¹¹;
- (2) to assure that each of its displayed market quotations are for the number of contracts required by Rule 8.6(a), “Market-Maker Firm Quotes”;
- (3) to segregate in a manner prescribed by the Exchange (a) all transactions consummated by the DPM in securities allocated to the DPM and (b) any other transactions consummated by or on behalf of the DPM that are related to the DPM’s DPM business¹²;
- (4) to not initiate a transaction for the DPM’s own account that would result in putting into effect any stop or stop limit order that may be in the Book¹³ and when the

¹⁰ To the extent there is any inconsistency between the specific obligations of a DPM set forth in proposed Rule 8.17 and the general obligations of a Market-Maker under the Exchange Rules, proposed Rule 8.17 will govern.

¹¹ For purposes of this provision, “continuous” means 90% of the time. If a technical failure or limitation of the System prevents a DPM from maintaining, or from communicating to the Exchange, timely and accurate quotes in a series, the duration of such failure will not be considered in determining whether that that [sic] DPM has satisfied the 99% quoting standard with respect to the series.

¹² This will permit the Exchange to monitor each DPM’s trading positions in order to ensure that the DPM is in compliance with the financial and other requirements that are applicable DPMs.

¹³ The term “Book” means the electronic book of buy and sell orders and quotes maintained

DPM guarantees that the stop or stop limit order will be executed at the same price as the electing transaction¹⁴; and

(5) to ensure that a trading rotation is initiated promptly following the opening of the underlying security (or promptly after 8:30 a.m. Central Time in an index class) in accordance with Rule 6.11 in 100% of the series of each allocated class by entering opening quotes as necessary.

Proposed Rule 8.17(b) provides that a DPM may not represent discretionary orders as an agent in its allocated classes.

Proposed Rule 8.17(c) lists additional obligations of a DPM, including that a DPM must:

(1) resolve disputes relating to transactions in the securities allocated to the DPM, subject to Exchange official review, upon the request of any party to the dispute;

(2) make competitive markets on the Exchange and otherwise promote the Exchange in a manner that is likely to enhance the ability of the Exchange to compete successfully for order flow in the classes it trades;

(3) promptly inform the Exchange of any material change in the financial or operational condition of the DPM;

(4) supervise all persons associated with the DPM to assure compliance with the Exchange Rules;

(5) segregate in a manner prescribed by the Exchange the DPM's business and activities as a DPM from the DPM's other business and activities¹⁵; and

by the System. The "System" is the automated trading system used by the Exchange for the trading of options contracts. See Rule 1.1.

¹⁴ These restrictions apply to stop or stop limit orders only if the terms of such orders are visible to the DPM or if such orders are handled by the DPM.

¹⁵ This requirement will help reduce the risk that a DPM's financial integrity will be

(6) continue to act as a DPM and to fulfill all of the DPM's obligations as a DPM until its DPM appointment has lapsed, the Exchange relieves the DPM of its approval and obligations to act as a DPM, or the Exchange terminates the DPM's approval to act as a DPM pursuant to proposed Rule 8.20.

Proposed Rule 8.17(d) provides that each person associated with a DPM will be obligated to comply with the provisions of proposed Rule 8.17(a) through (c) when acting on behalf of the DPM.

Proposed Rule 8.17(e) provides that each DPM must hold the number of Trading Permits as may be necessary based on the aggregate "registration cost" for the classes allocated to the DPM. Each Trading Permit held by the DPM has a registration cost of 1.0.¹⁶ For example, if the Exchange allocates to a DPM classes with an aggregate registration cost of 1.6, the DPM would be required to hold two Trading Permits. The Exchange may change at any time the registration cost of any option class; upon any such change, each DPM will be required to hold the appropriate number of Trading Permits reflecting the revised registration costs of the classes that have been allocated to it. Additionally, a DPM is required to hold the appropriate number of Trading Permits at the time a new option class is allocated to it pursuant to proposed Rule 8.16 begins trading.

In the event a Participant approved as a DPM is also approved to act as a Market-Maker and has excess Trading Permit capacity above the aggregate registration cost for the classes allocated to it as the DPM, the Participant may utilize the excess Trading Permit capacity to quote in an appropriate number of classes in the capacity of a Market-Maker. For example, if the

adversely impacted by financial losses that may be incurred by the DPM in connection with its other businesses and activities.

¹⁶ Rule 8.2(d) lists the registration costs for the classes of securities on the Exchange.

DPM has been allocated a number of option classes with an aggregate registration cost of 1.6, the Participant could request an appointment as a Market-Maker in any combination of option classes whose aggregate registration cost does not exceed 0.40. The Participant will not function as a DPM in any of these additional classes. In the event the Participant utilizes any excess Trading Permit capacity to quote in some additional classes as a Market-Maker, it must comply with the provisions of Rule 8.2.

Rule 8.17, Interpretation and Policy .01 clarifies that willingness of a DPM to promote the Exchange as a marketplace includes assisting in meeting and educating Participants (and taking the time for travel related thereto), maintaining communications with Participants in order to be responsive to suggestions and complaints, responding to suggestions and complaints, and other like activities.

The Exchange believes that these obligations will result in additional liquidity and competitive quoting in the allocated classes on C2's market, which could ultimately lead to additional order flow directed to the Exchange. The Exchange believes that these obligations will strengthen its market and are reasonable given the benefits conferred upon DPMs in exchange for these heightened obligations in the form of a participation entitlement, as discussed further below.

Rule 8.18 – DPM Financial Requirements¹⁷

Proposed Rule 8.18 requires each DPM to maintain net liquidating equity in its DPM account of not less than \$100,000. It also requires each DPM to maintain net capital sufficient to comply with the requirements of Rule 15c3-1 under the Act and requires each DPM that is a

¹⁷ See CBOE Rule 8.86.

Clearing Participant¹⁸ also to maintain net capital sufficient to comply with the requirements of The Options Clearing Corporation. Additionally, proposed Rule 8.18 requires DPMs to maintain net liquidating equity in their DPM accounts in conformity with any guidelines as the Exchange may establish from time to time. The Exchange expects to draft and use DPM financial guidelines in connection with the process for allocating securities to DPMs, and proposed Rule 8.18 would permit the Exchange to implement and enforce these guidelines as DPM financial requirements under Exchange Rules. The Exchange will announce these guidelines to Participants by Regulatory Circular. Although there are other rules that already subject DPMs to these financial requirements (and all Market-Makers must comply with the Act requirements applicable to specialists, including financial requirements), the Exchange believes that it is worthwhile to also include these requirements in proposed Rule 8.18 so that the proposed DPM Rules are more informative and complete.

Rule 8.19 – Participation Entitlement of DPMs¹⁹

Rule 6.12 sets forth how the System prioritizes orders for execution purposes. Rule 6.12(a)(3) provides that the Exchange may prioritize orders using a price-time priority with primary priority for public customers and secondary priority for certain trade participation rights. Proposed Rule 8.19 grants to DPMs a trade participation right. Proposed Rule 8.19(a) gives the Exchange authority to determine the appropriate participation right for DPMs by providing that the Exchange, subject to review by the Exchange Board of Directors, may establish from time to time a participation entitlement formula that is applicable to all DPMs.

¹⁸ A “Clearing Participant” means a Permit Holder that has been admitted to membership in The Options Clearing Corporation (“OCC”) pursuant to the provisions of OCC rules. A “Permit Holder” means the Exchange recognized holder of a Trading Permit. A Permit Holder is also known as a Trading Permit Holder under the Exchange’s Bylaws. Permit Holders are deemed “members” under the Act. See Rule 1.1.

¹⁹ See CBOE Rule 8.90 [sic].

Proposed Rule 8.19(b)(1) provides that: (1) a DPM will be entitled to a participation entitlement only if quoting at the best bid or offer disseminated on the Exchange (“BBO”); (2) a DPM may not be allocated a total quantity greater than the quantity that the DPM is quoting at the BBO; and (3) the participation entitlement is based on the number of contracts remaining after all public customer orders in the Book at the BBO have been satisfied.

Proposed Rule 8.19(b)(2) provides that the collective DPM participation entitlement shall be: 50% when there is one Market-Maker also quoting at the BBO and 40% when there are two or more Market-Makers also quoting at the BBO. If only the DPM is quoting at the BBO (with no Market-Makers quoting at the BBO), the participation entitlement will not be applicable and the allocation procedures under Rule 6.12 will apply.

Proposed Rule 8.19(b)(3) provides that a DPM will not receive its participation entitlement in trades for which a Preferred Market-Maker (“PMM”) already received a participation entitlement pursuant to Rule 8.13, based on the priority determination made by the Exchange under Rule 6.12. This provision clarifies that only one trade participation right may be applied to the same trade (see the discussion of the proposed rule change to Rule 6.12(a) below). For example, if the Exchange has activated both a PMM participation right and DPM participation right in a class and determines under Rule 6.12 that a PMM has higher priority than a DPM, and a PMM receives its participation entitlement for a trade, then a DPM may not receive its participation entitlement for that trade.

Proposed Rule 8.19, Interpretation and Policy .01 provides that the Exchange may also establish a lower DPM participation rate on a product-by-product basis for newly listed products or products that are being allocated to a DPM for the first time. The Exchange will announce any lower participation rate to Participants by Regulatory Circular.

The Exchange believes that DPMs will play an important role in providing additional liquidity and more price competition because of the obligations imposed on DPMs by the proposed Rules, as discussed above. The Exchange also believes that the proposed participation entitlement, which DPMs may receive only when quoting at the best price, is an appropriate reward for DPMs' satisfaction of their DPM obligations, particularly given the overall benefit to the Exchange's market and customers that the additional DPM liquidity will create. Further, the Exchange believes that the limited percentage of the participation entitlement still provides other market participants with opportunities to be allocated a significant number of contracts in trades in which a DPM receives its participation entitlement. Similarly, the Exchange believes it is appropriate to only allow a PMM or DPM to receive its participation entitlement for a trade to further ensure that these opportunities are available to other market participants in classes with a DPM or PMM. While the Exchange believes that DPMs will add liquidity to the benefit of the market and customers, it is still important for all market participations to engage in price competition on the Exchange. This participation entitlement is part of the Exchange's careful balancing of the rewards and obligations of all types of Exchange Participants, which is part of the overall market structure designed to encourage vigorous price competition among Market-Makers, while still maximizing the benefits or price competition resulting from the entry of customer and non-customer orders, while encouraging Participants to provide market depth.

Rule 8.20 – Termination, Conditioning, or Limiting Approval to Act as a DPM²⁰

Proposed Rule 8.20 governs the termination, conditioning, and limiting of approval to act as a DPM. Rule 8.20(a) provides that the Exchange may terminate, place conditions upon, or limit a Participant's approval to act as a DPM if the Participant: (1) incurs a material financial or

²⁰ See CBOE Rule 8.90.

operational; (2) fails to comply with any requirements under Exchange Rules regarding DPM obligations and responsibilities; or (3) is no longer eligible to act as DPM or be allocated a particular security or securities. Proposed Rule 8.20(a) also provides that before the Exchange may take any action to terminate, condition, or otherwise limit a Participant's approval to act as a DPM, the Participant will be given notice of such possible action and an opportunity to present any matter that it wishes the Exchange to consider in determining whether to take such action. These proceedings will be conducted in the same manner as the Exchange proceedings concerning DPM approvals described above.

Proposed Rule 8.20(b) provides an exception to this provision, which grants authority to the Exchange to immediately terminate, condition, or otherwise limit a Participant's approval to act as a DPM if the DPM incurs a material financial or operational warranting immediate action or if the DPM fails to comply with any of the financial requirements applicable to DPMs.

In addition, proposed Rule 8.20(c) provides that limiting a Participant's approval to act as a DPM may include, among other things, limiting or withdrawing a DPM's participation entitlement and withdrawing a DPM's right to act as DPM in one or more of its allocated securities.

As discussed above, it is important for the Exchange to have the sole authority to approve a Participant to act as a DPM (and allocate securities to a DPM) to ensure that the Participant is able to satisfy DPM obligations and perform DPM functions. Similarly, the Exchange needs authority to terminate, condition, or limit a DPM's approval when necessary to incentive DPMs to meet their DPM obligations and responsibilities in order to continue to receive the corresponding DPM benefits provided for in the proposed DPM Rules. In addition, if any of the circumstances set forth in proposed Rule 8.20(a) occurs, the Exchange's authority to terminate,

condition, or limit a DPM's approval, and appoint another DPM if necessary (in the interim or permanently as discussed above), is essential to provide for uninterrupted DPM quoting in appointed classes and prevent any reduced liquidity in the DPM's allocated class that could otherwise result under these circumstances.

Proposed Rule 8.20(d) provides that if a Participant's approval to act as a DPM is terminated, conditioned, or otherwise limited by the Exchange pursuant to proposed Rule 8.20, the Participant may appeal that decision to the Appeals Committee under Chapter 19. Additionally, as is described above, these appeal procedures provide for the right to a formal Appeals Committee hearing concerning any such decision, and the decision of the Appeals Committee may be appealed to the Board of Directors. The advanced notice and appeal procedures are intended to ensure that DPMs receive appropriate due process with respect to their approvals to act as DPMs, as discussed above.

Rule 8.21 – Limitations on Dealings of DPMs and Affiliated Persons of DPMs²¹

Proposed Rule 8.21 provides that a DPM must maintain information barriers that are reasonably designed to prevent the misuse of material, non-public information with any affiliates that may conduct a brokerage business in option classes allocated to the DPM or act as a specialist or market-maker in any security underlying options allocated to the DPM, and otherwise comply with the requirements of CBOE Rule 4.18 (which is incorporated into the Exchange Rules) regarding the misuse of material non-public information. A DPM must provide its information barriers to the Exchange and obtain prior written approval. This provision is meant to prevent a Participant's non-DPM businesses from obtaining any benefits as a result of the Participant's status as a DPM.

²¹ See CBOE Rule 8.91.

Rule 6.12 – Order Execution and Priority²²

The proposed rule change amends Rule 6.12 to ensure that the Exchange's order execution and priority rule contemplates a participation entitlement for DPMs. The proposed rule change provides that both PMMs and DPMs may be granted participation rights up to the applicable participation right percentage designated in Rule 8.13 and 8.19, respectively. The Exchange may activate more than one trade participation right for an option class (including at different priority sequences), however in no case may more than one trade participation right be applied on the same trade.²³ The proposed rule change provides that, like for PMMs, (1) a DPM's order or quote must be at the best price on the Exchange; (2) a DPM may not be allocated a total quantity greater than the quantity that it is quoting (including orders not part of quotes) at that price; (3) in establishing the counterparties to a particular trade, the DPM's participation right must be first counted against its highest priority bids or offers; and (4) the DPM's participation right will only apply to any remaining balance of an order once all higher priorities are satisfied.

The proposed rule change also amends Rule 6.12 to add paragraph (b)(2), which will provide for an additional priority overlay for small orders that can be applied to each of the three

²² See CBOE Rules 6.45A(a)(ii)(2) and (iii) and 6.45B(a)(i)(2) and (iii).

²³ For example, the Exchange may activate both the PMM trade participation right of Rule 8.13 and the DPM trade participation right of Rule 8.20, along with other priorities that are allowed under Rule 6.12(a)(3), for an option class at the following priority levels: public customer has first priority, Market Turner (see Rule 6.12(b)(1)) has second priority, PMM participation right has third priority, and DPM participation right has fourth priority. If a PMM's participation right is applied to a trade, then the DPM's participation right cannot be applied to that trade, and the trade would be allocated as follows: first to any public customers, second to the Market Turner, third to the PMM's participation right, and the remainder to other orders in price-time priority. However, if a PMM's participation right was not applied to the trade, then the DPM's participation right could be applied to the trade, and the trade would be allocated as follows: first to any public customers, second to the Market Turner, third to the DPM's participation right, and the remainder to other orders in price-time priority.

matching algorithms. If the small order priority overlay is in effect for an option class,²⁴ then the following would apply:

- Orders for five contracts or fewer will be executed first by the DPM that is appointed to the option class; provided, however, that, on a quarterly basis, the Exchange will evaluate what percentage of the volume executed on the Exchange (excluding volume resulting from the execution of orders in C2's Automated Improvement Mechanism ("AIM") – see Rule 6.51) is comprised of orders for five contracts or fewer executed by DPMs, and will reduce the size of the orders included in this provision if this percentage is over 40%.
- This procedure will only apply to the allocation of executions among non-customer orders and Market-Maker quotes existing in the Book at the time the Exchange receives the order. No market participant will be allocated any portion of an execution unless it has an existing interest at the execution price. Moreover, no market participant will be able to execute a greater number of contracts than is associated with the price of its existing interest. As a result, the small order preference contained in this allocation procedure will not be a guarantee; the DPM (1) must be quoting at the execution price to receive an allocation of any size, and (2) cannot execute a greater number of contracts than the size that is associated with its quote.
- If a PMM is not quoting at a price equal to the national best bid or offer (the "NBBO") at the time a preferred order is received, the allocation procedure for small orders described above will be applied to the execution of the preferred order (i.e., it will

²⁴ As set forth in Rule 6.12(b), the Exchange may determine to apply, on a series-by-series basis, any additional priority overlays in subparagraph (b) in a sequence determined by the Exchange.

be executed first by the DPM). If a PMM is quoting at the NBBO at the time the preferred order is received, the allocation procedure in place for all other sized orders in the class will be applied to the execution of the preferred order, except that any Market Turner status will not apply (e.g., if the default matching algorithm is price-time with a public customer and participation entitlement overlay, the order will execute first against any public customer orders, then the PMM would receive its participation entitlement, then the remaining balance would be allocated on a price-time basis).

- The small order priority overlay will only be applicable to automatic executions and will not be applicable to any auctions.²⁵

Lastly, like the existing priority overlays, the small order priority overlay is optional. The Exchange will announce all determinations under this Rule by Regulatory Circular.

As described above, the Exchange believes that because DPMs will have unique obligations to the C2 market,²⁶ they should be provided with certain participation rights. Under the proposed DPM Rules in this filing, if the DPM is one of the Participants with a quote at the best price, the participation entitlement will generally equal to 50% when there is one Market-Maker also quoting at the BBO or 40% when there are two or more Market-Makers also quoting at the BBO.²⁷ This proposed priority overly [sic] will make available an allocation procedure that provides that the DPM has precedence to execute orders of five contracts or fewer. The Exchange believes that this small order priority overlay will not necessarily result in a significant

²⁵ In addition to AIM, C2 has various electronic auctions that are described under Rules 6.14, “Simple Auction Liaison,” and 6.52, “Solicitation Auction Mechanism.” Each of these auctions generally allocates executions pursuant to the matching algorithm in effect for the options class with certain exceptions noted in the respective rules.

²⁶ See proposed Rule 8.17, “DPM Obligations.”

²⁷ See proposed amendment to Rule 6.12(a) and proposed Rule 8.19, “Participation Entitlement of DPMs.”

portion of the Exchange's volume being executed by the DPM. As stated above, the DPM would execute against these small orders only if it is quoting at the best price, and only for the number of contracts associated with its quotation. Nevertheless, the Exchange will evaluate what percentage of the volume executed on the Exchange is comprised of orders for five contracts or fewer executed by DPMs, and will reduce the size of the orders included in this provision if this percentage is over 40%.

C2 considered this small order priority overlay as part of its balancing of DPM obligations and benefits described above and believes this priority overlay, which includes participation rights for DPMs only when they are quoting at the best price, helps strike an appropriate balance of these obligations and benefits.

Other Changes

Rule 1.1 – Definitions

The proposed rule change amends Rule 1.1 to define the term “BBO” as the best bid or offer disseminated on the Exchange. The Exchange proposes to include this definition to clarify its meaning in the Exchange Rules because the term is used throughout the proposed DPM Rules as well as other Exchange Rules.

Rule 17.50 – Minor Rule Violation Plan²⁸

The proposed rule change also amends Rule 17.50(g)(14) to add DPM quoting obligations to the Exchange's Minor Rule Violation Plan (“MRVP”) provision regarding C2 Market-Maker quoting obligations. This will allow the Exchange to impose sanctions upon DPMs for failing to meet their quoting obligations pursuant to the MRVP, as it does for Market-Makers and PMMs. C2 believes these violations are suitable for inclusion in the MRVP because

²⁸ See CBOE Rule 17.50(g)(14).

they are generally technical in nature, allowing C2 to carry out its regulatory responsibilities more quickly and efficiently with respect to Market-Maker quoting obligations. For violations of DPM's quoting obligations, the Exchange may assess fines ranging from \$2,000 to \$4,000 for a first offense and \$4,000 to \$5,000 for a second offense, and may assess a fine of \$5,000 or refer to C2's Business Conduct Committee any subsequent offenses. The Exchange notes that these fine amounts are the same as the amounts currently imposed on Market-Makers for violations of their quoting obligations under the MRVP.

C2 will maintain internal guidelines that dictate the sanctions that will be imposed for a particular violation (based on the degree of the violation). As with all other violations in C2's MRVP, C2 will retain the ability to refer a violation of DPM quoting obligations to its Business Conduct Committee should the circumstances warrant this referral.

2. Statutory Basis

The Exchange believes the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to the Exchange and, in particular, the requirements of Section 6(b) of the Act.²⁹ Specifically, the Exchange believes the proposed rule change is consistent with the Section 6(b)(5)³⁰ requirements that the rules of an exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts, to remove impediments to and to perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest.

In particular, the Exchange believes that adopting a DPM program will protect investors and the public interest, because it will help generate greater order flow for the Exchange in appointed classes and provide additional incentives for DPMs to trade with that order flow,

²⁹ 15 U.S.C. 78f(b).

³⁰ 15 U.S.C. 78f(b)(5).

which in turn adds depth and liquidity to C2's market and ultimately benefits all market participants. The Exchange believes this deeper liquidity will make C2 more competitive with other markets that trade those classes, which will also help remove impediments to and perfect the mechanism for a free and open market.

Additionally, the Exchange believes that adopting a DPM program will promote just and equitable principles of trade, as it will require DPMs to assist in the maintenance of a fair and orderly market, as reasonably practicable, and maintain net capital consistent with federal requirements for market-makers. These proposed Rules impose many obligations on DPMs, including continuous two-sided quoting obligations, which will ensure that DPMs provide significant liquidity in their allocated classes to the benefit of all C2 market participants, and operational capacity requirements, which will ensure that DPMs are capable of carrying out their obligations, as well as eligibility requirements and market performance standards. The proposed Rules also allow the Exchange to impose conditions on DPMs or their allocations to further ensure that DPMs are providing appropriate depth and liquidity in their allocated classes.

In light of these obligations, the Exchange also proposed to provide DPMs with the benefit of a participation entitlement that may receive higher priority for trades than other Participants, subject to the requirements set forth in proposed Rule 8.19(b)(1), as well as a small order priority overlay, subject to the requirements set forth in proposed Rule 6.12(b)(2). While these trade priorities may reduce the number of contracts that other Participants may execute in trades in which the DPM participation entitlement, or small order priority overlay is applied, the Exchange believes this fact is outweighed by the benefit of the additional liquidity and more competitive pricing that DPMs will provide to the market in their appointed classes, ultimately resulting in a net benefit to Exchange customers. These trade priorities are part of the balancing

of C2's overall market structure, which is designed to encourage vigorous price competition between Market-Makers on the Exchange, as well as maximize the benefits of price competition resulting from the entry of customer and non-customer orders, while encouraging Participants to provide market depth. Therefore, the Exchange believes the obligations proposed to be imposed on DPMs are offset by the benefits proposed to be conferred upon DPMs.

In addition, the Exchange believes that the approval and allocation procedures and policies will ensure that Participants are approved to act as DPMs and securities traded on the Exchange are allocated in an equitable manner, and that all DPMs will have a fair opportunity for approvals and allocations based on established criteria and procedures. The proposed rules that give the Exchange the authority to terminate, limit, or condition DPM approvals or reallocate securities will allow the Exchange to ensure that its market maintains an uninterrupted high level of liquidity for customers in allocated classes, even when unusual or changing market circumstances exist. Further, the Exchange believes that the advanced notice provisions and appeal procedures that the proposed rules put in place for all determinations made by the Exchange with respect to DPM approvals and allocations, including termination and reallocation decisions, are reasonable procedures that will create a fair and equitable decision-making process with respect to DPMs.

The Exchange believes the proposed rule change to add violations of DPM quoting obligation to C2's MRVP will strengthen C2's ability to carry out its regulatory responsibilities as a self-regulatory organization pursuant to the Act and reinforce its surveillance and enforcement functions.

The Exchange believes that adding the definition of BBO to the Rules protects investors and the public interest, as it clarifies the meaning of this term, which is used throughout the proposed DPM Rules and other Exchange Rules, for investors.

Finally, the Exchange believes that the proposed rule change is consistent with the requirements of the Act because, as the Exchange notes above, the proposed requirements for DPMs are based primarily on existing requirements for DPMs on another exchange (CBOE).

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

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period up to 90 days (i) as the Commission may designate if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove the proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

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:

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. Please include File No. SR-C2-2012-024 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 No. SR-C2-2012-024. 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 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 C2. 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 No. SR-C2-2012-024 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³¹

Kevin M. O'Neill
Deputy Secretary

³¹ 17 CFR 200.30-3(a)(12).