

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-61152; File No. 10-191]

### In the Matter of the Application of C2 Options Exchange, Incorporated for Registration as a National Securities Exchange Findings, Opinion, and Order of the Commission

December 10, 2009.

#### I. Introduction

On January 21, 2009, the Chicago Board Options Exchange, Incorporated (“CBOE”) submitted to the Securities and Exchange Commission (“Commission”) an Application for Registration as a National Securities Exchange (“Form 1”) seeking registration under Section 6 of the Securities Exchange Act of 1934<sup>1</sup> (the “Act”) of a second national securities exchange, referred to as C2 Options Exchange, Incorporated (“C2” or the “Exchange”). Notice of the application was published for comment in the *Federal Register* on March 3, 2009.<sup>2</sup> The Commission received one comment letter regarding the C2 Form 1.<sup>3</sup> On December 8, 2009, C2 filed Amendment No. 1 to its Form 1.<sup>4</sup>

#### II. Statutory Standards

Under Sections 6(b) and 19(a) of the Act,<sup>5</sup> the Commission shall by order grant an application for registration as a national securities exchange if it finds that the proposed exchange is so

<sup>1</sup> 15 U.S.C. 78f.

<sup>2</sup> See Securities Exchange Act Release No. 59441 (February 24, 2009), 74 FR 9322 (“Notice”).

<sup>3</sup> See E-mails from Bryan Rule, dated July 8, 2009 and November 9, 2009. While the July correspondence does not contain any substantive comments on the Form 1 application, the November correspondence asks the Commission not to approve C2’s application for registration until CBOE “adequately disciplines its members for their large number of SEC Firm Quote violations \* \* \*.” Mr. Rule asserted that “the new C2 Rules seek to diminish the public’s priority in option trading.” As discussed further below, the Commission believes that C2’s proposed rules, including provisions relating to order execution and priority, are consistent with the Act. In addition, as a self-regulatory organization, C2—as well as CBOE—is required to comply with the provisions of the Act and the rules and regulations thereunder and enforce compliance with such provisions by its members. See 15 U.S.C. 78s(g).

<sup>4</sup> In Amendment No. 1, CBOE modified its application by: Revising Exhibits C and D to reflect the removal of entities that do not qualify as affiliates and to provide more current financial information; revising its proposed Bylaws to clarify an inconsistency in Section 3.1; revising Exhibit J to reflect current information; and revising and clarifying the operation of certain proposed rules. The changes proposed in Amendment No. 1 either are not material or are otherwise responsive to the concerns of the Commission.

<sup>5</sup> 15 U.S.C. 78f(b) and 15 U.S.C. 78s(a), respectively.

organized and has the capacity to carry out the purposes of the Act and can comply, and can enforce compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulations thereunder, and the rules of the exchange.

As discussed in greater detail below, the Commission finds that C2’s application for exchange registration meets the requirements of the Act and the rules and regulations thereunder. Further, the Commission finds that the proposed rules of C2 are consistent with Section 6 of the Act in that, among other things, they are designed to: (1) Assure fair representation of the Exchange’s members in the selection of its directors and administration of its affairs and provide that, among other things, one or more directors shall be representative of investors and not be associated with the exchange, or with a broker or dealer;<sup>6</sup> (2) prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, remove impediments to and perfect the mechanisms of a free and open market and a national market system;<sup>7</sup> (3) not permit unfair discrimination between customers, issuers, or dealers;<sup>8</sup> and (4) protect investors and the public interest.<sup>9</sup> Finally, the Commission finds that the proposed rules of C2 do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.<sup>10</sup>

Overall, the Commission believes that approving C2’s application for exchange registration could confer important benefits on the public and market participants. In particular, C2 will provide market participants with an additional venue for executing orders in standardized options and should increase competition between the options exchanges. Consequently, investors should benefit as markets compete on service, price, and execution.

#### III. Discussion and Commission Findings

##### A. Background

CBOE, a national securities exchange registered under Section 6 of the Act, has proposed the formation of C2 as a

<sup>6</sup> See 15 U.S.C. 78f(b)(3).

<sup>7</sup> See 15 U.S.C. 78f(b)(5).

<sup>8</sup> See *id.*

<sup>9</sup> See *id.*

<sup>10</sup> See 15 U.S.C. 78f(b)(8).

stand-alone options exchange that will operate under a separate exchange license and have separate access rules, separate governance, and a separate fee schedule from that of CBOE. Unlike CBOE, which uses a hybrid model market structure, C2 will be an all-electronic marketplace and will not maintain a physical options trading floor. CBOE filed its C2 proposal during a time of increasing consolidation among U.S. registered exchanges in which exchange holding companies have sought to control multiple, separate exchange licenses in order to offer multiple and varied trading venues to appeal to a broad array of market participants.<sup>11</sup> The primary features of the C2 proposal, discussed in more detail in C2’s Form 1, are discussed below.

##### B. Corporate Structure of C2

###### 1. Ownership

C2 will be a wholly-owned subsidiary of its parent company, CBOE. The C2 governing documents explicitly state that CBOE owns 100% of the common stock of C2 and that any sale, transfer, or assignment by CBOE of its ownership stake in C2 will not be permitted without Commission approval pursuant to the rule filing procedures under Section 19 of the Act.<sup>12</sup> CBOE, itself a self-regulatory organization (“SRO”), will therefore own C2, which will be a separate SRO.<sup>13</sup>

While recent consolidation among U.S. exchanges has involved ownership of multiple exchanges under a single holding company structure, that structure is unavailable to CBOE, which presently is structured as a mutually-held member-owned organization. CBOE has, however, proposed to demutualize, though its C2 proposal

<sup>11</sup> See, e.g., Securities Exchange Act Release Nos. 58179 (July 17, 2008), 73 FR 42874 (July 23, 2008) (File No. SR-Phlx-2008-31) (approval order concerning changes to the governing documents of the Philadelphia Stock Exchange, Inc. in connection with its acquisition by The NASDAQ OMX Group, Inc.); and 58673 (September 29, 2008), 73 FR 57707 (October 3, 2008) (File Nos. SR-Amex-2008-62 and SR-NYSE-2008-60) (approval order concerning the acquisition of the American Stock Exchange LLC by NYSE Euronext).

<sup>12</sup> See Article Fourth of the Certificate of Incorporation of C2 (“C2 Certificate of Incorporation”). See also 15 U.S.C. 78s.

<sup>13</sup> The acquisition of the American Stock Exchange LLC (“Amex”) by the National Association of Securities Dealers, Inc. (“NASD”) in 1998 involved a similar corporate structure. See Securities Exchange Act Release No. 40622 (October 30, 1998), 63 FR 59819 (November 5, 1998) (File Nos. SR-Amex-98-32; SR-NASD-98-56; and SR-NASD-98-67) (approval order).

precedes its efforts to effectuate its planned demutualization.<sup>14</sup>

The Commission notes that, while C2 will be responsible for complying with the legal obligations that govern an exchange, CBOE, in its capacity as the parent company with a controlling interest in C2, also will be responsible for ensuring that C2 meets its obligations as an SRO. In this respect, CBOE has adopted a rule to reflect and codify CBOE's ultimate responsibility to ensure that C2 meets its statutory obligations as an SRO.<sup>15</sup> Among other things, CBOE's policy with respect to C2 represents that CBOE will ensure that necessary and appropriate resources are available to C2 so that it can meet the evolving demands of operating a regulatory and supervisory compliance program. Further, in discharging this responsibility, CBOE's policy states it will exercise its powers and its managerial influence to ensure that C2 fulfills its self-regulatory obligations by directing C2 to take action necessary to effectuate its purposes and functions as a national securities exchange operating pursuant to the Act, and ensuring that C2 has and appropriately allocates such financial, technological, technical, and personnel resources as may be necessary or appropriate to meet its obligations under the Act. Finally, CBOE has committed to refrain from taking any action with respect to C2 that, to the best of its knowledge, would impede, delay, obstruct, or conflict with efforts by C2 to carry out its SRO obligations under the Act, and the rules and regulations thereunder. The Commission believes that CBOE's policy statement specifies the role and responsibility of CBOE in the operation of C2.

The Commission believes that the proposed corporate structure of C2 is consistent with the Act and that C2 will be so organized and have the capacity to be able to carry out the purposes of

<sup>14</sup> CBOE's planned demutualization has been noticed for comment but has not yet received member approval. See Securities Exchange Act Release No. 58425 (August 26, 2008), 73 FR 51652 (September 4, 2008) (File No. SR-CBOE-2008-88) ("CBOE Demutualization Notice").

<sup>15</sup> See Securities Exchange Act Release Nos. 61140 (December 10, 2009) (File No. SR-CBOE-2009-048) (approval order); and 60307 (July 15, 2009), 74 FR 36289 (July 22, 2009) (File No. SR-CBOE-2009-048) (notice of filing). The policy adopted by CBOE is consistent with the resolution of similar questions in the context of the NASD-Amex combination referenced above. See Securities Exchange Act Release Nos. 40622 (October 30, 1998), 63 FR 59819 (November 5, 1998) (File Nos. SR-Amex-98-32; SR-NASD-98-56; and SR-NASD-98-67) (approval order); and 40443 (September 16, 1998), 63 FR 51108 (September 24, 1998) (File No. SR-NASD-98-67) (notice of filing of NASD's policy with respect to its authority over the Amex).

the Act and to comply and enforce compliance by its members and persons associated with its members with all applicable rules and regulations. C2's proposed ownership by CBOE, coupled with the explicit restriction on any indirect or direct transfer of such control by CBOE, should minimize the potential that any person could interfere with or restrict the ability of C2, CBOE, or the Commission to effectively carry out their respective regulatory oversight responsibilities. Further, the Commission notes that CBOE has undertaken to ensure and maintain the regulatory independence of C2 to enable C2 to operate in a manner that complies with the Federal securities laws, including the objectives of Sections 6(b) and 19(g) of the Act.<sup>16</sup>

## 2. Governance

As part of its Form 1 application, C2 submitted a proposed Certificate of Incorporation and Bylaws. In these documents, among other things, C2 establishes the composition of the Exchange's board of directors and the Exchange's governance committees.<sup>17</sup>

### a. The C2 Board of Directors

C2's Board of Directors ("Board") will be the governing body of C2 and will possess all of the powers necessary for the management of the business and affairs of the Exchange and the execution of its responsibilities as an SRO, including regulating the business conduct of Trading Permit Holders ("TPHs"), imposing fees, and adopting and amending rules.<sup>18</sup> C2 has proposed the following Board composition requirements, which are comparable to those the Commission has approved for other SROs:<sup>19</sup>

- The Board will be composed of between 11 and 23 directors (the exact number to be fixed from time to time by the Board);<sup>20</sup>
- One director position will be held by the Chief Executive Officer of C2 ("CEO");
- The number of Non-Industry Directors<sup>21</sup> will equal or exceed the sum

<sup>16</sup> 15 U.S.C. 78f(b) and 15 U.S.C. 78s(g), respectively.

<sup>17</sup> The governance structure of C2 is based primarily upon the governance structure that CBOE has proposed in connection with its demutualization. See CBOE Demutualization Notice, *supra* note 14, at 73 FR 51654.

<sup>18</sup> See C2 Bylaws Article III, Section 3.3.

<sup>19</sup> See, e.g., Section 9 of the Limited Liability Company Agreement of The NASDAQ Stock Market LLC ("Nasdaq") and Article III of Nasdaq's By-Laws.

<sup>20</sup> See C2 Bylaws Article III, Section 3.1.

<sup>21</sup> "Non-Industry Director" is defined as a person who is not an "Industry Director." See *id.*

of the number of Industry Directors<sup>22</sup> (excluding the CEO from the calculation of Industry Directors for such purpose);

- At all times, at least one Non-Industry Director will qualify as a Non-Industry Director other than by operation of the limited exceptions provided for "outside directors" under the definition of "Industry Director" and will have no material business relationship with a broker or dealer, an entity that is affiliated with a broker-dealer, or the Exchange or any of its affiliates;<sup>23</sup>

- The number of Industry Directors will equal or exceed 30% of the Board;<sup>24</sup> and

- At least 20% of the directors on the Board will be nominated (or otherwise selected by a petition of C2 members) by the Industry-Director Subcommittee of

<sup>22</sup> C2's Bylaws define "Industry Director" as a director that: (i) is a holder of a Trading Permit or otherwise subject to regulation by the Exchange; (ii) is a broker-dealer or an officer, director or employee of a broker-dealer or has been in any such capacity within the prior three years; (iii) is, or was within the prior three years, associated with an entity that is affiliated with a broker-dealer whose revenues account for a material portion of the consolidated revenues of the entities with which the broker-dealer is affiliated; (iv) has a material ownership interest in a broker-dealer and has investments in broker-dealers that account for a material portion of the director's net worth; (v) has a consulting or employment relationship with or has provided professional services to the Exchange or any of its affiliates or has had such a relationship or has provided such services within the prior three years; or (vi) provides, or has provided within the prior three years, professional or consulting services to a broker-dealer, or to an entity with a 50% or greater ownership interest in a broker-dealer whose revenues account for a material portion of the consolidated revenues of the entities with which the broker-dealer is affiliated, and the revenue from all such professional or consulting services accounts for a material portion of either the revenues received by the director or the revenues received by the director's firm or partnership. See *id.*

<sup>23</sup> C2's Bylaws provide a limited exception such that a director would not be deemed to be an "Industry Director" solely because either (A) the person is or was within the prior three years an outside director of a broker-dealer or an outside director of an entity that is affiliated with a broker-dealer, provided that the broker-dealer is not a holder of a Trading Permit or otherwise subject to regulation by the Exchange, or (B) the person is or was within the prior three years associated with an entity that is affiliated with a broker-dealer whose revenues do not account for a material portion of the consolidated revenues of the entities with which the broker-dealer is affiliated, provided that the broker-dealer is not a holder of a Trading Permit or otherwise subject to regulation by the Exchange. At all times, however, at least one Non-Industry Director must qualify as a Non-Industry Director exclusive of the exceptions provided for in the immediately preceding sentence and shall have no material business relationship with a broker or dealer or the Exchange or any of its affiliates. C2's Bylaws specify that the term "outside director" means a director of an entity who is not an employee or officer (or any person occupying a similar status or performing similar functions) of such entity. See *id.*

<sup>24</sup> See *id.*

the Nominating and Governance Committee (such directors are referred to collectively as the "Representative Directors").<sup>25</sup>

The initial Board will be divided into two classes. The initial term of the Class I and II directors will end with the annual stockholders meeting to be held by the Exchange in 2009 and 2010, respectively. Thereafter, directors will serve two-year terms ending on the second annual meeting following the meeting at which such directors were elected. Class I directors will initially consist of the Chief Executive Officer, five Non-Industry Directors, and five Industry Directors (two of whom will be Representative Directors). Class II directors will initially consist of seven Non-Industry Directors and five Industry Directors (three of whom will be Representative Directors).<sup>26</sup> All directors will continue in office until their successors are elected or appointed and qualified, except in the event of their earlier death, resignation, or removal.<sup>27</sup>

In addition, within 45 days from the date on which trading commences on C2, the Industry-Director Subcommittee will issue a circular to TPHs identifying a slate of Representative Director nominees.<sup>28</sup> TPHs will thereafter be able to file petitions for the nomination of alternate Representative Directors. In the event of a contested election, a run-off election will be held prior to the initial Board election. The Commission notes that because CBOE intends to seed the initial C2 Board with members of CBOE's current board of directors, the Representative Directors on C2's initial Board will have been subject to CBOE member input. As C2's initial permit holders will likely consist substantially of CBOE members,<sup>29</sup> the Commission believes C2's initial Board will provide member representation sufficient to allow the Exchange to commence operations. However, to assure a fair

<sup>25</sup> Only persons who are nominated by the Nominating and Governance Committee as Representative Directors will be eligible for election as Representative Directors and the Nominating and Governance Committee is bound to accept and nominate the Representative Director nominees recommended by the Industry-Director Subcommittee, provided that the Representative Director nominees are not opposed by a petition candidate. If such Representative Director nominees are opposed by a petition candidate then the Nominating and Governance Committee is bound to accept and nominate the Representative Director nominees who receive the most votes pursuant to a run-off election. See C2 Bylaws Article III, Section 3.2.

<sup>26</sup> See C2 Bylaws Article III, Section 3.1, and Amendment No. 1.

<sup>27</sup> See C2 Bylaws Article III, Section 3.1.

<sup>28</sup> See C2 Bylaws Article III, Section 3.2.

<sup>29</sup> See *infra* Section III.C.1.a (TPH Access).

representation of C2 members in the selection of C2's directors and administration of its affairs, C2 has committed to provide C2 members with the prompt opportunity to participate in the selection of Representative Directors, thereby satisfying the compositional requirements for the Board contained in the C2 Bylaws.<sup>30</sup>

The Nominating and Governance Committee will nominate individuals for election as directors of the Board subsequent to the initial Board election process set forth above.<sup>31</sup> The Board will appoint the initial Nominating and Governance Committee and thereafter the Nominating and Governance Committee members will recommend their successors for approval by the Board.

The Industry-Director Subcommittee<sup>32</sup> of the Nominating and Governance Committee will recommend candidates to the Nominating and Governance Committee for each new or vacant Representative Director position on the Board.<sup>33</sup> Alternate candidates for Representative Director positions may be nominated by TPHs pursuant to a petition process.<sup>34</sup> If no candidates are nominated pursuant to a petition process, then the Nominating and Governance Committee is bound to accept and nominate the Representative Director nominees recommended by the Industry-Director Subcommittee. If a petition process produces additional candidates, then the candidates nominated pursuant to a petition process, together with those nominated by the Industry-Director Subcommittee, will be presented to TPHs in a contested election to determine the final slate of nominees for Representative Director.<sup>35</sup>

<sup>30</sup> See C2 Bylaws Article III, Section 3.2.

<sup>31</sup> See C2 Bylaws Article III, Section 4.5. The Nominating and Governance Committee will be comprised of at least seven directors and will at all times have a majority of directors that are Non-Industry Directors. See *id.*

<sup>32</sup> The Industry-Director Subcommittee will consist of all of the Industry Directors then serving on the Nominating and Governance Committee. See C2 Bylaws Article III, Section 3.2.

<sup>33</sup> The Industry-Director Subcommittee will provide a mechanism for TPHs to provide input to the Industry-Director Subcommittee with respect to open Representative Director positions. Once selected, the Industry-Director Subcommittee will issue a circular to TPHs identifying the Representative Director nominees selected by the committee. See C2 Bylaws Article III, Section 3.2.

<sup>34</sup> See C2 Bylaws Article III, Section 3.2. TPHs may nominate alternative candidates for election to the Representative Director positions to be elected in a given year by submitting a petition signed by individuals representing not less than 10% of the total outstanding Trading Permits at that time. See *id.*

<sup>35</sup> See C2 Bylaws Article III, Section 3.2. Each TPH will have one vote with respect to each Trading Permit held for each Representative Director position to be filled that year; provided,

Candidates who receive the most votes will be nominated as Representative Directors by the Nominating and Governance Committee.<sup>36</sup> CBOE, as the sole shareholder of C2, has committed to elect the candidates nominated by the Nominating and Governance Committee as Representative Directors.<sup>37</sup>

The Commission believes that the requirement in the C2 Bylaws that 20% of directors be Representative Directors, together with the process by which such directors are to be nominated and elected, provides for the fair representation of members in the selection of directors and the administration of C2 in a manner consistent with the requirement in Section 6(b)(3) of the Act.<sup>38</sup> As the Commission has previously noted in the context of other exchange governance proposals, this requirement helps to ensure that an exchange's members have a voice in the governing body of the exchange and the corresponding exercise by the exchange of its self-regulatory authority, and that the exchange is administered in a way that is equitable to all who trade on its market or through its facilities.<sup>39</sup>

In addition, the requirement that the number of Non-Industry Directors equal or exceed the number of Industry Directors on the Board is designed to assure the inclusion of a significant non-industry presence in the governance of the Exchange, which the Commission believes is a critical element in an exchange's ability to protect the public interest.<sup>40</sup> Further, the Commission notes that at all times at least one Non-Industry Director will qualify as not an "Industry Director" without using the limited exceptions provided for "outside directors" under the definition of "Industry Director" and will have no

however, that no holder of Trading Permits, either alone or together with its affiliates, may account for more than 20% of the votes cast for a candidate, and any votes cast by a holder of Trading Permits, either alone or together with its affiliates, in excess of this 20% limitation will be disregarded. See *id.*

<sup>36</sup> See *id.*

<sup>37</sup> CBOE, as sole shareholder of C2, has entered into a voting agreement with C2 with respect to the election by CBOE of the Representative Directors whereby CBOE has agreed to vote in favor of those individuals nominated by C2's Nominating and Governance Committee for election as Representative Directors of C2.

<sup>38</sup> 15 U.S.C. 78f(b)(3).

<sup>39</sup> See, e.g., Securities Exchange Act Release Nos. 53128 (January 13, 2006), 71 FR 3550, 3553 (January 23, 2006) (File No. 10-131) ("Nasdaq Exchange Registration Order"); 53382 (February 27, 2006), 71 FR 11251, 11259 (March 6, 2006) (File No. SR-NYSE-2005-77) ("NYSE/Archipelago Merger Approval Order"); and 58375 (August 18, 2008), 73 FR 49498, 49501 (August 21, 2008) (File No. 10-182) ("BATS Exchange Registration Order").

<sup>40</sup> See, e.g., Nasdaq Exchange Registration Order, *supra* note 39, at 71 FR 3553.

material business relationship with a broker or dealer, an entity that is affiliated with a broker-dealer, or the Exchange or any of its affiliates.<sup>41</sup> In other words, at least one of C2's directors will not have any association with C2, a member of C2, or a broker or dealer, consistent with Section 6(b)(3) of the Act.<sup>42</sup>

The Commission believes that non-industry directors help ensure that no single group of market participants has the ability to unfairly disadvantage other market participants through the exchange governance process. Non-industry directors can provide unique and unbiased perspectives, which should enhance the ability of the Board to address issues in a non-discriminatory fashion and consequently support the integrity of C2's governance.<sup>43</sup> Accordingly, the Commission finds that C2's proposed Board satisfies the requirements in Section 6(b)(3) of the Act,<sup>44</sup> which requires that one or more directors be representative of issuers and investors and not be associated with a member of the exchange, or with a broker or dealer.

#### b. C2 Exchange Committees

C2 has proposed to establish the following standing committees of the Board: Executive Committee;<sup>45</sup> Audit Committee;<sup>46</sup> Compensation Committee;<sup>47</sup> Regulatory Oversight

Committee;<sup>48</sup> and Nominating and Governance Committee.<sup>49</sup> The Board will appoint the initial members of the Nominating and Governance Committee, and thereafter the Nominating and Governance Committee will promptly act to recommend candidates for the other committees of the Board. Members of the standing committees will not be subject to removal except by the Board.<sup>50</sup> The Commission believes that C2's proposed committees, which are similar to the committees maintained by other exchanges,<sup>51</sup> are designed to enable C2 to carry out its responsibilities under the Act and are consistent with the Act.

#### C. Regulation of C2

As a prerequisite for the Commission's approval of an exchange's application for registration, an exchange must be organized and have the capacity to carry out the purposes of the Act.<sup>52</sup> Specifically, an exchange must be able to enforce compliance by its members, and persons associated with its members, with the Federal securities laws and the rules of the exchange.<sup>53</sup>

approval by the Board. The exact number of Compensation Committee members will be determined from time to time by the Board. The Chairman of the Compensation Committee will be recommended by the Nominating and Governance Committee for approval by the Board.

<sup>48</sup> See C2 Bylaws, Article IV, Section 4.6. The Regulatory Oversight Committee will consist of at least four directors, all of whom will be Non-Industry Directors and all of whom will be recommended by the Non-Industry Directors on the Nominating and Governance Committee for approval by the Board. The exact number of Regulatory Oversight Committee members will be determined from time to time by the Board. The Chairman of the Regulatory Oversight Committee will be recommended by the Non-Industry Directors of the Nominating and Governance Committee for approval by the Board.

<sup>49</sup> See C2 Bylaws, Article IV, Section 4.5. The Nominating and Governance Committee will consist of at least seven directors, including both Industry Directors and Non-Industry Directors, and will at all times have a majority of directors that are Non-Industry Directors. All members of the committee, except for the initial members of the committee (appointed to the committee in accordance with Section 4.1 of the Bylaws), will be recommended by the Nominating and Governance Committee for approval by the Board. The exact number of Nominating and Governance Committee members will be determined from time to time by the Board. The Chairman of the Nominating and Governance Committee will be recommended by the Nominating and Governance Committee for approval by the Board. Subject to Section 3.2 and Section 3.5 of the Bylaws, the Nominating and Governance Committee will have the authority to nominate individuals for election as directors of the Corporation.

<sup>50</sup> See, e.g., C2 Bylaws, Article IV, Section 4.5.

<sup>51</sup> See BATS Exchange Registration Order, *supra* note 39, at 73 FR 49501; and Nasdaq Exchange Registration Order, *supra* note 39, at 71 FR 3554.

<sup>52</sup> See Section 6(b)(1) of the Act, 15 U.S.C. 78f(b)(1).

<sup>53</sup> See *id.* See also Section 19(g) of the Act, 15 U.S.C. 78s(g).

C2 has not proposed to be a party to any regulatory services agreements or bilateral plans for the allocation of regulatory responsibilities pursuant to Rule 17d-2 of the Act, though it will become a party to the existing multiparty options 17d-2 plans concerning sales practice regulation and market surveillance.<sup>54</sup>

C2 proposes to use "dual hat" employees to staff its regulatory program. In other words, current CBOE employees will also serve in a similar capacity for C2. Similar to other exchanges, C2 has proposed a requirement that confidential information (e.g., disciplinary matters, trading data, trading practices, and audit information) pertaining to the self-regulatory function of C2 will be retained in confidence by C2 and its officers, directors, employees, and agents.<sup>55</sup>

As discussed further below, the Commission believes that C2's application for registration describes a market structure that is designed to provide for sufficient regulatory oversight of C2 members and the operation of C2 as an SRO, as required by the Act. The Commission notes that C2 will have the statutory authority and responsibility to, among other things, discipline its members, amend its Bylaws and rules, list and delist securities, and grant or deny membership in C2. Further, the Commission believes that the use of "dual hat" employees by C2 is appropriate, as the operations, rules, and management of CBOE and C2 will overlap to a considerable degree such that C2 should benefit by leveraging the experience of current CBOE staff. However, the Commission expects both CBOE and C2 to monitor the workload of their dual hat employees and supplement their staffs if necessary so that C2 maintains sufficient personnel to allow it to carry out the purposes of the Act and enforce compliance with the rules of C2 and the Federal securities laws.

<sup>54</sup> See Securities Exchange Act Release Nos. 57987 (June 18, 2008), 73 FR 36156 (June 25, 2008) (File No. S7-966) (notice of filing and order approving and declaring effective an amendment to the multiparty 17d-2 plan concerning options-related sales practice matters); and 58765 (October 9, 2008), 73 FR 62344 (October 20, 2008) (File No. 4-551) (notice of filing and order approving and declaring effective an amendment to the multiparty 17d-2 plan concerning options-related market surveillance). See also *infra* Section III.C.3 (Multiparty 17d-2 Agreements); and 17 CFR 240.17d-2.

<sup>55</sup> See Article Eleventh of the C2 Certificate of Incorporation. See also, e.g., Article VII of the Second Amended and Restated Operating Agreement of the New York Stock Exchange LLC (containing a similar provision).

<sup>41</sup> See C2 Bylaws Article III, Section 3.1.

<sup>42</sup> 15 U.S.C. 78f(b)(3).

<sup>43</sup> See, e.g., Nasdaq Exchange Registration Order, *supra* note 39, at 71 FR 3553; and NYSE/Archipelago Merger Approval Order, *supra* note 39, at 71 FR 11261.

<sup>44</sup> 15 U.S.C. 78f(b)(3).

<sup>45</sup> See C2 Bylaws, Article IV, Section 4.2. The Executive Committee will include the Chairman of the Board, the Chief Executive Officer (if a director), the Vice Chairman of the Board, the Lead Director, if any, at least one Representative Director and such other number of directors that the Board deems appropriate, provided that in no event will the number of Non-Industry Directors constitute less than the number of Industry Directors serving on the Executive Committee (excluding the Chief Executive Officer from the calculation of Industry Directors for such purpose). Members of the Executive Committee (other than those specified in the immediately preceding sentence) will be recommended by the Nominating and Governance Committee for approval by the Board.

<sup>46</sup> See C2 Bylaws, Article IV, Section 4.3. The Audit Committee will consist of at least three directors, all of whom will be Non-Industry Directors and all of whom will be recommended by the Nominating and Governance Committee for approval by the Board. The exact number of Audit Committee members will be determined from time to time by the Board. The Chairman of the Audit Committee will be recommended by the Nominating and Governance Committee for approval by the Board.

<sup>47</sup> See C2 Bylaws, Article IV, Section 4.4. The Compensation Committee will consist of at least three directors, all of whom will be Non-Industry Directors and all of whom will be recommended by the Nominating and Governance Committee for

## 1. Membership and Access

## a. TPH Access

Membership on C2 will be available to any registered broker or dealer that meets the standards for membership set forth in Chapter 3 of C2's proposed rules.<sup>56</sup> Members will access C2 through trading permits, which will not convey any ownership interest in the Exchange but will confer the ability to transact on the Exchange. There is no limit on the number of permits that C2 is authorized to issue.<sup>57</sup> Permits will not be transferable except in the event of a change in control of a TPH, subject to meeting certain criteria.<sup>58</sup> There will be two types of TPHs: (1) Market makers with certain affirmative and negative obligations and (2) regular TPHs.<sup>59</sup>

Each CBOE member in good standing will be eligible to obtain one trading permit on C2 regardless of the number of seats owned by that CBOE member.<sup>60</sup> CBOE member applicants will not be required to submit a full application for membership on C2, but rather will only need to complete selected forms concerning their election to trade on C2, consent to C2's jurisdiction, and other operational matters.<sup>61</sup> This waive-in process is similar to arrangements in place at other SROs.<sup>62</sup>

Non-CBOE members could apply for a C2 trading permit by submitting a full application to the Exchange in a manner similar to the current process for firms applying to membership on CBOE.<sup>63</sup> C2 will establish, and will distribute via regulatory circular, procedures that outline submission deadlines and payment of any applicable application fees.<sup>64</sup> Pursuant to C2's rules, every applicant must have and maintain

membership in another options exchange that is registered under the Act and that is not registered solely under Section 6(g) of the Act.<sup>65</sup>

The Exchange will receive and review all trading permit applications, and will provide to the applicant written notice of the Exchange's determination, specifying in the case of disapproval of an application the grounds thereof.<sup>66</sup> The Exchange also will register and qualify associated persons of permit holders.<sup>67</sup> Once an applicant becomes a TPH or a person associated with a TPH, it must continue to satisfy all of the qualifications set forth in the C2 rules.<sup>68</sup> When the Exchange has reason to believe that a member or associated person or a member fails to meet such qualifications, the Exchange may suspend or revoke such person's membership or association.<sup>69</sup> Appeals from any denial, suspension, or conditional approval will be heard pursuant to the appeals process specified in Chapter 19.<sup>70</sup>

The Commission finds that C2's membership rules are consistent with Section 6 of the Act,<sup>71</sup> including Section 6(b)(2) of the Act<sup>72</sup> in particular, which requires that a national securities exchange have rules that provide that any registered broker or dealer or natural person associated with such broker or dealer may become a member and any person may become associated with an exchange member. The Commission notes that pursuant to Section 6(c) of the Act,<sup>73</sup> an exchange must deny membership to any person, other than a natural person, that is not a registered broker or dealer, any natural person that is not, or is not associated with, a registered broker or dealer, and registered broker-dealers that do not satisfy certain standards, such as financial responsibility or operational capacity. As a registered exchange, C2

must independently determine if an applicant satisfies the standards set forth in the Act, regardless of whether an applicant is a member of another SRO (e.g., CBOE).<sup>74</sup>

## b. Non-TPH Access

C2 proposes to permit access to non-TPH "Sponsored Users" whose access is authorized in advance by a TPH ("Sponsoring Participant").<sup>75</sup> C2's proposed "Sponsored Users" rule is similar to rules of other SROs that provide for sponsored access.<sup>76</sup> Specifically, the Sponsoring Participant must agree to be responsible for all orders entered into on C2 by the Sponsored User. In addition, Sponsored Users must agree to comply with all applicable rules of C2 governing the entry, execution, reporting, clearing, and settling of orders in securities eligible for trading on C2 and the Sponsored User must agree that it will be bound by and comply with the Exchange's rules as if the Sponsored User were a Permit Holder.<sup>77</sup> Sponsored Participants will also be required by C2 rules to enter into a "Sponsored User Agreement" with their Sponsoring Permit Holder setting forth the obligations of both parties.

## c. Linkage

C2 intends to become a participant in the Plan Relating to Options Order Protection and Locked/Crossed Markets or any successor plan ("Linkage Plan").<sup>78</sup> If admitted as a participant to the Linkage Plan, other plan participants (including CBOE) would be able to send orders to C2 in accordance with the terms of the Linkage Plan.

C2 will incorporate by reference the Intermarket Linkage rules contained in Section E of Chapter VI of CBOE's rulebook, as such rules may be in effect from time to time. Accordingly, C2's proposed Linkage rules will include relevant definitions, establish the conditions pursuant to which members may enter Linkage orders, impose obligations on the Exchange regarding how it must process incoming Linkage

<sup>56</sup> See C2 Rule 3.1(b). If a TPH intends to transact business with the public, it will be required to obtain approval pursuant to C2 Rule 9.1 or must have been previously approved to transact business with the public by another national securities exchange. See *id.*

<sup>57</sup> While C2 does not anticipate reaching any capacity limits, it has proposed a rule that will allow C2, in the event of a capacity restriction, to limit access to new market makers pursuant to a filing with the Commission. See C2 Rule 8.1(c). This proposed rule is similar to a rule of Nasdaq. See Nasdaq Rule Chapter VII, Section 2(c).

<sup>58</sup> See C2 Rule 3.1(d).

<sup>59</sup> See C2 Rules 3.1 and 8.1. See also Exhibit E to C2's Form 1 (describing the operation of the proposed Exchange).

<sup>60</sup> See C2 Rule 3.1(c)(1).

<sup>61</sup> See *id.*

<sup>62</sup> See, e.g., Nasdaq Rule 1013(a)(5)(C) (containing a similar expedited waive-in membership process for members of the Financial Industry Regulatory Authority, Inc. ("FINRA")).

<sup>63</sup> See C2 Rule 3.1(c)(2).

<sup>64</sup> See *id.* The Commission notes that C2 will be required to file any such proposed fees pursuant to Section 19(b) of the Act and Rule 19b-4 thereunder, 15 U.S.C. 78s(b) and 17 CFR 240.19b-4, respectively.

<sup>65</sup> See C2 Rule 3.1(c)(2)(G).

<sup>66</sup> See C2 Rule 3.1(c)(2)(E) and (F). The Exchange also could condition an applicant's approval for the reasons specified in C2 Rule 3.2.

<sup>67</sup> See C2 Rules 3.3 and 3.4. See also Amendment No. 1.

<sup>68</sup> See C2 Rule 3.2(c)(1).

<sup>69</sup> See, e.g., C2 Rule 3.2 (Denial of and Conditions to Being a Permit Holder or an Associated Person); 3.4 (Qualification and Registration); and 3.5 (Permit Holders and Persons Associated with a Permit Holder Who Are or Become Subject to a Statutory Disqualification). See also Amendment No. 1.

<sup>70</sup> See *infra* note 117 (regarding Chapter 19). C2's Chapter 19 rules (Hearings and Review) incorporate by reference CBOE's Chapter 19 rules and C2 participants will be required to comply with CBOE Chapter 19 rules, as such rules may be in effect from time to time, as if such rules were part of the C2 rules.

<sup>71</sup> 15 U.S.C. 78f.

<sup>72</sup> 15 U.S.C. 78f(b)(2).

<sup>73</sup> 15 U.S.C. 78f(c).

<sup>74</sup> See, e.g., BATS Exchange Registration Order, *supra* note 39, at 73 FR 49502; and Nasdaq Exchange Registration Order, *supra* note 39, at 71 FR 3555.

<sup>75</sup> See C2 Rule 3.15.

<sup>76</sup> See, e.g., CBOE Rule 6.20A (Sponsored Users).

<sup>77</sup> See C2 Rule 3.15(b)(1)(B)(iii).

<sup>78</sup> See Securities Exchange Act Release No. 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009) (File No. 4-546) (order approving the national market system Plan Relating to Options Order Protection and Locked/Crossed Markets Submitted by the Chicago Board Options Exchange, Incorporated, International Securities Exchange, LLC, The NASDAQ Stock Market LLC, NASDAQ OMX BX, Inc., NASDAQ OMX PHLX, Inc., NYSE Amex LLC, and NYSE Arca, Inc.) ("Linkage Plan").

orders, establish a general standard that members and the Exchange should avoid trade-throughs, establish potential regulatory liability for members that engage in a pattern or practice of trading through other exchanges, and establish obligations with respect to locked and crossed markets.

The Commission believes that C2 has proposed rules that are designed to comply with the requirements of the Linkage Plan.<sup>79</sup> Further, before C2 can commence operations as an exchange, C2 must become a participant in the Linkage Plan.

#### d. Market Makers

##### i. Registration of Market Makers

A TPH may register with C2 as a market maker by filing a written application with C2, which will consider an applicant's market making ability and other factors it deems appropriate in determining whether to approve an applicant's registration.<sup>80</sup> All market makers will be designated as specialists on C2 for all purposes under the Act and rules thereunder.<sup>81</sup> C2 will not limit the number of qualifying entities that may become market makers.<sup>82</sup> The good standing of a market maker may be suspended, terminated, or withdrawn if the conditions for approval cease to be maintained or if the market maker violates any of its agreements with C2 or any provisions of the C2 rules.<sup>83</sup>

The Commission finds that C2's proposed market maker qualifications requirements are consistent with the Act. In particular, C2's rules provide an objective process by which a TPH could become a market maker on C2 and provide for appropriate continued

oversight by the Exchange to monitor for continued compliance by market makers with the terms of their application for such status. The Commission notes that C2's proposed market maker registration requirements are similar to those of other options exchanges.<sup>84</sup>

##### ii. Market Maker Obligations

Pursuant to C2 rules, the transactions of a market maker in its market making capacity must constitute a course of dealings reasonably calculated to contribute to the maintenance of a fair and orderly market.<sup>85</sup> Among other things, a market maker must: (1) Maintain a two-sided market on a continuous basis (defined as 99% of the time) in 60% of the series of each registered class that have a time to expiration of less than nine months;<sup>86</sup> (2) engage in dealings for their own accounts when there is a lack of price continuity, a temporary disparity between the supply of and demand for a particular option contract, or a temporary distortion of the price relationships between options contracts of the same class; (3) compete with other market makers; (4) update quotations in response to changed market conditions; (5) maintain active markets; and (6) make markets that will be honored for the number of contacts entered.<sup>87</sup> C2 will impose an upper limit on the aggregate number of market makers that may quote in each product ("Class Quoting Limit" or "CQL"). The CQL will be set at 50 market makers, and could be increased or decreased for an existing or new product.<sup>88</sup> If C2 finds any substantial or continued failure by a market maker to engage in a course of dealings as specified in Rule 8.5(a), then such market maker will be subject to disciplinary action, suspension, or revocation of registration in one or more of the securities in which the market maker is registered.<sup>89</sup> In addition, market makers must maintain minimum net capital in accordance with Commission and C2 rules.<sup>90</sup> Market makers must also maintain information

barriers that are reasonably designed to prevent the misuse of material, non-public information.<sup>91</sup>

The Commission notes that market makers receive certain benefits for carrying out their responsibilities.<sup>92</sup> For example, a lender may extend credit to a broker-dealer without regard to the restrictions in Regulation T of the Board of Governors of the Federal Reserve System if the credit is used to finance the broker-dealer's activities as a specialist or market maker on a national securities exchange.<sup>93</sup> In addition, market makers are excepted from the prohibition in Section 11(a) of the Act.<sup>94</sup> The Commission believes that a market maker must have sufficient affirmative obligations, including the obligation to hold itself out as willing to buy and sell options for its own account on a regular or continuous basis, to justify this favorable treatment.<sup>95</sup> The Commission further believes that the rules of all U.S. options markets need not provide the same standards for market maker participation, so long as they impose affirmative obligations that are consistent with the Act.<sup>96</sup> The Commission believes that C2's market maker participation requirements impose sufficient affirmative obligations on C2 market makers and, accordingly, that C2's requirements are consistent with the Act. In particular, the Commission notes that the Act does not mandate a particular market model for exchanges, and while market makers may become an important source of liquidity on C2, they will likely not be the only source as C2 is designed to match buying and selling interest of all participants on C2.<sup>97</sup> The Commission therefore believes that C2's proposed structure is consistent with the Act.

#### 2. Regulatory Independence

C2 has proposed several measures to help ensure the independence of its

<sup>79</sup> The Commission notes that it has approved CBOE rules to accommodate the Linkage Plan. See Securities Exchange Act Release No. 60551 (August 20, 2009), 74 FR 43196 (August 26, 2009) (File No. SR-CBOE-2009-040). These amended rules will be incorporated by reference into C2's rulebook. See C2 Rules Chapter 6, Section E (Intermarket Linkage). See also *infra* Section IV (discussing the Section 36 exemption).

<sup>80</sup> See C2 Rule 8.1(a). In considering a TPH's application for registration as a market maker on C2, the provision permitting the Exchange to consider "such other factors as the Exchange deems appropriate" must be applied consistent with the Act, including that the Exchange's rules must not be unfairly discriminatory.

<sup>81</sup> See C2 Rule 8.1.

<sup>82</sup> See C2 Rule 8.1(c). However, C2 may limit access to the C2 system based on system constraints, capacity restrictions, or other factors relevant to protecting the integrity of the system, pending action required to address the issue of concern. To the extent that C2 places limitations on access to the system on any TPH, such limits will be objectively determined and submitted to the Commission via a proposed rule change filed under Section 19(b) of the Act. See *id.*

<sup>83</sup> See C2 Rule 8.4(b).

<sup>84</sup> See, e.g., Nasdaq Rules, Chapter VII, Sections 2 and 4; Boston Options Exchange Rules, Chapter VI, Section 2; and International Securities Exchange Rule 804.

<sup>85</sup> See C2 Rule 8.5(a).

<sup>86</sup> While not specified in the rule text, the Commission notes that a market maker's quote would need to be represented by a size of at least 1 contract.

<sup>87</sup> See C2 Rule 8.5(a) and Amendment No. 1.

<sup>88</sup> See C2 Rule 8.11. Any such changes to the CQL would be announced by C2 in an Information Circular, and would be filed with the Commission pursuant to Section 19(b)(1) of the Act (15 U.S.C. 78s(b)). See C2 Rule 8.11(b) and (c).

<sup>89</sup> See C2 Rule 8.5(c).

<sup>90</sup> See C2 Rule 8.4(a)(1).

<sup>91</sup> See C2 Rule 8.9. The Commission notes that, as with any rule of an exchange, C2 will be responsible, pursuant to Sections 6 and 19 of the Act (15 U.S.C. 78f and 15 U.S.C. 78s, respectively), for enforcing compliance with Rule 8.9, which will require C2 to conduct periodic examinations of its market maker members with this rule.

<sup>92</sup> See, e.g., Securities Exchange Act Release No. 57478 (March 12, 2008), 73 FR 14521, 14526 (March 18, 2008) (File No. SR-NASDAQ-2007-004) (approval order concerning the establishment of the NASDAQ Options Market LLC ("NOM")) ("NOM Approval Order") (discussing the benefits and obligations of market makers).

<sup>93</sup> 12 CFR 221.5(c)(6).

<sup>94</sup> 15 U.S.C. 78k(a).

<sup>95</sup> See NOM Approval Order, *supra* note 92, at 73 FR 14526.

<sup>96</sup> See *id.*

<sup>97</sup> See, e.g., NOM Approval Order, *supra* note 92, at 73 FR 14527 (discussing NOM's single market maker requirement).

regulatory function from its market operations and other commercial interests. The regulatory operations of C2 will be monitored by the Regulatory Oversight Committee ("ROC"). The ROC will consist of at least four directors, all of whom will be Non-Industry Directors and all of whom will be recommended by the Non-Industry Directors on the Nominating and Governance Committee for approval by the Board. The ROC generally will be responsible for monitoring the adequacy and effectiveness of the Exchange's regulatory program, assessing the Exchange's regulatory performance, and assisting the Board in reviewing the Exchange's regulatory plan and the overall effectiveness of the Exchange's regulatory functions.<sup>98</sup> Further, a Chief Regulatory Officer of the Exchange will have general supervision over the Exchange's regulatory operations.<sup>99</sup> In addition, any revenues received by the Exchange from fees derived from its regulatory function or regulatory penalties will not be used for non-regulatory purposes.<sup>100</sup>

The Commission continues to be concerned about the potential for unfair competition and conflicts of interest between an exchange's self-regulatory obligations and its commercial interests that could exist if an exchange were to otherwise become affiliated with one of its members, as well as the potential for unfair competitive advantage that the affiliated member could have by virtue of informational or operational advantages, or the ability to receive preferential treatment.<sup>101</sup> To this end, C2 Rule 3.2(f) provides that without the prior approval of the Commission, C2 or any entity with which it is affiliated will not directly acquire or maintain an ownership interest in a C2 member, and a C2 member will not be or become an affiliate of C2 or an affiliate of C2.<sup>102</sup>

The Commission believes that the Exchange's proposed provisions relating to the regulatory independence of the Exchange are consistent with the Act, particularly with Section 6(b)(1), which requires an exchange to be so organized and have the capacity to carry out the purposes of the Act.<sup>103</sup>

### 3. Multiparty 17d-2 Agreements

Section 19(g)(1) of the Act<sup>104</sup> requires every SRO to examine its members and persons associated with its members and to enforce compliance with the Federal securities laws and the SRO's own rules, unless the SRO is relieved of this responsibility pursuant to Section 17(d) of the Act.<sup>105</sup> Section 17(d) was intended, in part, to eliminate unnecessary multiple examinations and regulatory duplication with respect to members of more than one SRO ("common members").<sup>106</sup> Rule 17d-2 of the Act permits SROs to propose joint plans allocating regulatory responsibilities concerning common members.<sup>107</sup> These agreements, which must be filed with and approved by the Commission, generally cover such regulatory functions as personnel registration and sales practices. Commission approval of a 17d-2 plan relieves the specified SRO of those regulatory responsibilities allocated by the plan to another SRO.<sup>108</sup> Many SROs have entered into 17d-2 agreements.<sup>109</sup> C2 currently does not intend to enter into any bilateral 17d-2 agreements, but rather will retain direct responsibility for all aspects of its operations as an SRO through the use of CBOE "dual hat" employees.<sup>110</sup> C2 does, however, plan to join the existing multiparty agreements concerning intermarket options surveillance.<sup>111</sup> Under these agreements, the examining SROs will

<sup>104</sup> 15 U.S.C. 78s(g)(1).

<sup>105</sup> 15 U.S.C. 78q(d).

<sup>106</sup> See Securities Exchange Act Release No. 12935 (October 28, 1976), 41 FR 49091 (November 8, 1976) ("Rule 17d-2 Adopting Release").

<sup>107</sup> 17 CFR 240.17d-2.

<sup>108</sup> See Rule 17d-2 Adopting Release, *supra* note 106.

<sup>109</sup> See, e.g., Securities Exchange Act Release Nos. 59218 (January 8, 2009), 74 FR 2143 (January 14, 2009) (File No. 4-575) (FINRA/Boston Stock Exchange, Inc.); 58818 (October 20, 2008), 73 FR 63752 (October 27, 2008) (File No. 4-569) (FINRA/BATS Exchange, Inc.); 55755 (May 14, 2007), 72 FR 28057 (May 18, 2007) (File No. 4-536) (National Association of Securities Dealers, Inc. ("NASD") n/k/a FINRA and CBOE concerning the CBOE Stock Exchange); 55367 (February 27, 2007), 72 FR 9983 (March 6, 2007) (File No. 4-529) (NASD/International Securities Exchange, LLC); and 54136 (July 12, 2006), 71 FR 40759 (July 18, 2006) (File No. 4-517) (NASD/Nasdaq).

<sup>110</sup> See *supra* text accompanying note 55 (regarding dual hat employees).

<sup>111</sup> See Securities Exchange Act Release Nos. 57987 (June 18, 2008), 73 FR 36156 (June 25, 2008) (File No. S7-966) (notice of filing and order approving and declaring effective an amendment to the multiparty 17d-2 plan concerning options-related sales practice matters) and 58765 (October 9, 2008), 73 FR 62344 (October 20, 2008) (File No. 4-551) (notice of filing and order approving and declaring effective an amendment to the multiparty 17d-2 plan concerning options-related market surveillance). See also Cover letter accompanying Amendment No. 1 (representing that C2 intends to join the options multiparty agreements).

examine firms that are common members of C2 and the particular examining SRO for compliance with certain provisions of the Act, certain rules and regulations adopted thereunder, and certain C2 rules.

### 4. Discipline and Oversight of Members

As noted above, one prerequisite for Commission approval of an exchange's application for registration is that a proposed exchange must be organized and have the capacity to carry out the purposes of the Act. Specifically, an exchange must be able to enforce compliance by its members and persons associated with its members with Federal securities laws and the rules of the exchange.<sup>112</sup>

C2 proposed to incorporate by reference<sup>113</sup> Chapter 17 of the CBOE rulebook relating to member discipline. As such, C2 members will be required to comply with Chapter 17 of the CBOE rulebook as such rules may be in effect from time to time, as if such rules were part of the C2 rulebook. In addition, C2 proposes to use "dual hat" employees, *i.e.*, current CBOE employees who will also serve in a similar capacity for C2, to administer its disciplinary and oversight functions. These C2 employees will, among other things, investigate potential securities laws violations, issue complaints, conduct hearings, and issue disciplinary decisions pursuant to C2 rules.<sup>114</sup>

Upon petition, appeals from disciplinary decisions rendered by C2 will be heard by the Board (or a committee of the Board composed of at least three directors whose decision will need to be ratified by the Board) and the Board's decision will be final.<sup>115</sup> In addition, the Board may on its own initiative order review of a disciplinary decision.<sup>116</sup>

Appeal of a denial, suspension, or termination of a trading permit will be heard by the Exchange's Appeals Committee.<sup>117</sup> Decisions of the Appeals

<sup>112</sup> See 15 U.S.C. 78f(b)(1).

<sup>113</sup> See *infra* Section IV (discussing an exemption from Section 19(b) of the Act for CBOE rules incorporated by reference by C2). Citations to incorporated CBOE rules herein are referred to as "C2" rules.

<sup>114</sup> See C2 Rules 17.2—17.9.

<sup>115</sup> See C2 Rule 17.10(b).

<sup>116</sup> See C2 Rule 17.10(c).

<sup>117</sup> See C2 Rule 19.4. The Commission notes that C2's Chapter 19 rules (Hearings and Review) incorporate by reference CBOE's Chapter 19 rules and C2 participants will be required to comply with CBOE Chapter 19 rules, as such rules may be in effect from time to time, as if such rules were part of the C2 rules. Further, the Commission notes that C2 will establish its own Appeals Committee that includes C2 participants. See Cover letter accompanying Amendment No. 1 (representing that C2 will establish its own Appeals Committee).

<sup>98</sup> See C2 Bylaws Article IV, Section 4.6.

<sup>99</sup> See Cover letter accompanying Amendment No. 1 (representing that, while not specified as an officer in the proposed Bylaws, C2 will have a Chief Regulatory Officer).

<sup>100</sup> See C2 Rule 2.3 and Amendment No. 1.

<sup>101</sup> See, e.g., NYSE/Archipelago Merger Approval Order, *supra* note 39, at 71 FR 11263.

<sup>102</sup> See C2 Rule 3.2(f). The rule would not prohibit a TPH from acquiring an equity interest in CBSX LLC and would not prohibit a TPH from being affiliated with One Chicago, LLC under limited conditions. See *id.*

<sup>103</sup> 15 U.S.C. 78f(b)(1).

Committee will be made in writing and will be sent to the parties to the proceeding.<sup>118</sup> The decisions of the Appeals Committee will be subject to review by the Board, on its own motion, or upon written request by the aggrieved party, the President of C2, or by the Chairman of the committee whose action was subject to the prior review of the Appeals Committee.<sup>119</sup> The Board, or a committee of the Board, will have sole discretion to grant or deny the request.<sup>120</sup> The Board, or a committee of the Board, will conduct the review of the Appeals Committee's decision and the Board may affirm, reverse, or modify the Appeals Committee's decision.<sup>121</sup>

C2 rules codify the Exchange's disciplinary jurisdiction over its members, thereby facilitating its ability to enforce its members' compliance with its rules and the Federal securities laws.<sup>122</sup> The Exchange's rules also permit it to sanction members for violations of its rules and violations of the Federal securities laws by, among other things, expelling or suspending members; limiting members' activities, functions, or operations; fining or censuring members; suspending or barring a person from being associated with a member; or any other appropriate sanction.<sup>123</sup>

The Commission finds that C2's proposed disciplinary and oversight rules and structure are consistent with the requirements of Sections 6(b)(6) and 6(b)(7) of the Act<sup>124</sup> in that they provide fair procedures for the disciplining of members and persons associated with members. The Commission further finds that the proposed C2 rules are designed to provide the Exchange with the ability to comply, and with the authority to enforce compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulations thereunder, and the rules of C2.<sup>125</sup>

#### D. The C2 Trading System

##### 1. Order Display, Execution, and Priority

C2 will operate a fully-automated electronic platform for trading standardized options with a continuous, automated matching function. Liquidity will be derived from market maker

quotes as well as orders to buy and sell submitted to C2 electronically by users (collectively, "Participants"). There will be no physical trading floor.

All orders/quotes submitted to C2 will be displayed unless designated otherwise by the Participant submitting the order (e.g., the non-displayed portion of a Reserve Order). The Exchange has represented that any top-of-book feed (or comparable market data feed) that it makes available to C2 members will also be made available to other market participants.<sup>126</sup>

Non-displayed orders will not be displayed to any Participants and will not have time priority over displayed orders.<sup>127</sup> While orders will generally be submitted on an anonymous basis, C2 will allow Participants on a voluntary basis to submit Attributable Orders, which will display the firm's identity along with the order to all market participants simultaneously.<sup>128</sup> In addition, Participants will be able to submit the following types of orders to C2: Day; Good 'til Canceled; Contingency (including All-Or-None, Immediate Or Cancel, Market On Close, Fill Or Kill, Stop, and Reserve); and Complex Orders (including Spreads, Combination, Straddle, Strangle, Ratio, Butterfly, Box/Roll, Collar and Risk Reversal).<sup>129</sup> The Commission notes that these order types are substantially similar to the order types offered by CBOE.<sup>130</sup>

The Commission believes that C2's proposed order types are consistent with the Act. Among other things, the Commission believes that C2's proposed order types appropriately provide priority to displayed orders and portions of orders over non-displayed orders and portions of orders, thereby encouraging the posting of displayed orders, which contribute visible depth to the displayed market.<sup>131</sup>

<sup>126</sup> See Cover letter accompanying Amendment No. 1 (representing that the Exchange will offer the data feed to all market participants). The Exchange noted that it may adopt fees for non-member access to a C2 data feed. See *id.* The Commission notes that C2 would be required to file any such proposed fees pursuant to Section 19(b) of the Act and Rule 19b-4 thereunder, 15 U.S.C. 78s(b) and 17 CFR 240.19b-4, respectively.

<sup>127</sup> See C2 Rule 6.12(a).

<sup>128</sup> NOM offers a similar attributable order type. See NOM Approval Order, *supra* note 92, at 73 FR 14528 (discussing NOM's attributable order type).

<sup>129</sup> See C2 Rule 6.10 (Order Types Defined) for additional information on each order type. See also Amendment No. 1 (revising the definition of Ratio Order).

<sup>130</sup> See CBOE Rules 6.53 and 6.53C.

<sup>131</sup> See, e.g., Securities Exchange Act Release Nos. 37619A (September 6, 1996), 61 FR 48290, 48294 (September 12, 2006) (File No. S7-30-95) (adopting Rule 11Ac1-4) ("The Commission believes that limit orders are a valuable component of price discovery. The uniform display of such orders will

After the open, trades on C2 will execute when a buy order/quote and a sell order/quote match on C2's order book. All orders will be matched according to one of two priority structures, as determined by C2 on a class-by-class basis: (1) Price-time priority or (2) pro-rata priority.<sup>132</sup> In addition, public customer and/or market turner priority<sup>133</sup> overlays will also be available at C2's discretion on a series-by-series basis.<sup>134</sup> In the event that less than the full size of an order is executed, the unexecuted portion of the order will continue to reside on C2's order book. The non-reserve portion of any partially-executed order will retain priority at the same price. Regardless of the priority structure, Contingency Orders will be last in priority because they are not displayed.

C2 will limit a Participant's ability to trade as principal with an order it represents as agent, unless the agency order is first given the opportunity to interact with other trading interest on the Exchange. Specifically, in order to trade as principal with an agency order a Participant represents, either: (1) The agency order is first exposed on C2 for at least 1 second;<sup>135</sup> (2) the Participant has been bidding or offering for at least 1 second prior to receiving an agency order that is executable against its bid or offer; or (3) the Participant uses the Automated Improvement Mechanism or Solicitation Auction Mechanism.<sup>136</sup>

encourage tighter, deeper, and more efficient markets."); and 57441 (March 6, 2008), 73 FR 13267 (March 12, 2008) (File No. SR-ISE-2007-95) (noting the incentive for market participants to display their trading interest in the context of reserve orders).

<sup>132</sup> Under pro rata priority, orders will be prioritized according to price. If there are two or more orders at the best price then trades will be allocated proportionally according to size. See C2 Rule 6.12(a)(2).

<sup>133</sup> C2 defines a "market turner" as a party that was the first to enter an order or quote at a better price than the previous best disseminated Exchange price and the order/quote is continuously in the market until it trades. The market turner priority at a given price could only be established after the opening rotation and would remain with the order once it is earned and last until the conclusion of the trading session. See C2 Rule 6.12(b)(2).

<sup>134</sup> C2 will issue a Regulatory Circular periodically that will specify which series are subject to these additional priorities, and will update the Regulatory Circular any time it makes a change to any of the designated priorities. See C2 Rule 6.12(b).

<sup>135</sup> All-or-none contingency orders on C2 will not be deemed "exposed" for purposes of Rule 6.50. See C2 Rule 6.50(c) and Amendment No. 1.

<sup>136</sup> See C2 Rule 6.50. See also proposed C2 Rule 1.1 (defining NBBO as the national best bid or offer). For purposes of the order exposure requirements contained in C2 Rule 6.50, all-or-none orders are not deemed exposed. See C2 Rule 6.50(c). The 1 second exposure period is consistent with the operation of the CBOE Hybrid System. See CBOE Rule 6.45A Interpretations and Policies .01 and .02

<sup>118</sup> See C2 Rule 19.4(e).

<sup>119</sup> See C2 Rule 19.5(a).

<sup>120</sup> See *id.*

<sup>121</sup> See C2 Rule 19.5(b). Decisions concerning denial of membership in an exchange are subject to review by the Commission.

<sup>122</sup> See generally C2 Rule 17.1.

<sup>123</sup> See C2 Rule 17.11.

<sup>124</sup> 15 U.S.C. 78f(b)(6) and (b)(7), respectively.

<sup>125</sup> See Section 6(b)(1) of the Act, 15 U.S.C. 78f(b)(1).



C2 may offer a Simple Auction Liaison (“SAL”) system to auction eligible agency orders and provide the opportunity for price improvement better than the NBBO.<sup>137</sup> C2 would designate the eligible order size, order type, and origin code (*i.e.*, public customer, non-market maker broker-dealer, or market maker order), and classes in which SAL may be activated. For classes in which SAL is activated, SAL will automatically initiate an auction process for a non-contingency order that is marketable against C2’s NBBO quote, except when C2’s disseminated quote on the opposite side does not contain sufficient market-maker quotation size to satisfy the entire order. Prior to commencing an auction, SAL would stop the order at the NBBO against the market maker quotes displayed at the NBBO on the opposite side. SAL auctions will last for a period of time not to exceed 2 seconds. Auction responses could be submitted by any Participant.<sup>138</sup> At the end of the auction, the agency order will first be allocated against public customer interest at the best price. Any remaining balance of the agency order will then be allocated pursuant to the matching algorithm in effect for the class.<sup>139</sup>

The Automated Improvement Mechanism (“AIM”) will allow Participants to cross an agency order they hold against principal interest or a solicited order provided that they first expose the agency order to a 1-second auction.<sup>140</sup> To be eligible for an AIM auction, at least three market makers must be quoting in the applicable series.<sup>141</sup> If the agency order is greater than 50 contracts, the Participant must stop the agency order at the NBBO (or the order’s limit price if better), and if it is less than 50 contracts, the Participant must stop the agency order at the NBBO improved by one minimum increment (or the order’s limit price if better).<sup>142</sup> When initiating an auction, a Participant submitting an agency orders to AIM must either indicate a single-price at which it seeks to cross the order or must indicate that it will match as principal the price and size of all auction responses.<sup>143</sup> Request for responses will then be sent to any Participant that has elected to receive such requests, and the exposure period

(regarding the 1 second exposure on the CBOE Hybrid System).

<sup>137</sup> See C2 Rule 6.14. C2’s SAL is based on CBOE’s SAL rule. See CBOE Rule 6.13A.

<sup>138</sup> See C2 Rule 6.14(b) and Amendment No. 1.

<sup>139</sup> See C2 Rule 6.14. See also CBOE Rule 6.13A.

<sup>140</sup> See C2 Rule 6.51.

<sup>141</sup> See C2 Rule 6.51(a)(4).

<sup>142</sup> See C2 Rule 6.51(a)(2) and (3).

<sup>143</sup> See C2 Rule 6.51(b)(1).

will last for 1 second.<sup>144</sup> If the auction attracts responses (which may be submitted by Participants),<sup>145</sup> the agency order will be allocated at the best price(s), and public customer orders in the book will have priority.<sup>146</sup> If the best price equals the initiating Participant’s single-price submission, then the initiating Participant will be allocated 40% of the order (or 50% in the case of a single price submission where only one other market maker matches the price).<sup>147</sup> C2’s proposed AIM is based on CBOE’s AIM rule.<sup>148</sup>

C2’s Solicitation Auction Mechanism (“SAM”) is based on CBOE’s SAM.<sup>149</sup> The SAM will allow Participants to execute agency orders of 500 or more contracts against solicited orders after a 1-second auction exposure. The orders must be designated as all-or-none, and the initiating Participant must signify a single price at which it seeks to cross the order. At the conclusion of the auction, the agency order will trade with the solicited order provided that the trade price of the agency order is equal to or better than C2’s best bid or offer.<sup>150</sup> Further, if there are any public customer orders resting in the book on the opposite side at the execution price with sufficient size to fill the agency order, then the agency order will be executed against the public customer interest and the solicited order will be cancelled. If the public customer order lacks sufficient size, then the agency order and solicited order will be cancelled. Likewise, if the auction generates a response at an improved price that contains sufficient size to fill the agency order, then the agency order will execute against the improved price and the solicited order will be cancelled.<sup>151</sup>

C2 also will make available certain additional order processing and matching features. For example, C2 will maintain a complex order book (“COB”) that permits any C2 market participant to enter complex orders into the COB to automatically execute against marketable orders and quotes resting in the book or against other complex

<sup>144</sup> See *id.*

<sup>145</sup> See C2 Rule 6.51(b)(1)(D) and Amendment No. 1.

<sup>146</sup> See C2 Rule 6.51(b)(3) and Amendment No. 1.

<sup>147</sup> See *id.*

<sup>148</sup> See C2 Rule 6.51. See also CBOE Rule 6.74A.

<sup>149</sup> See C2 Rule 6.52. See also CBOE Rule 6.74B.

<sup>150</sup> See C2 Rule 6.52(b)(2)(A)(i). If the trade would take place at a price outside of the C2 best bid or offer, then the agency order and solicited order would cancel. See *id.*

<sup>151</sup> See C2 Rule 6.52(b)(2)(A)(ii)–(iii). If the response does not contain sufficient size, then the agency order will trade with the solicited order. See *id.*

orders in the COB.<sup>152</sup> In addition, C2 will offer an optional complex order auction that will allow orders, prior to routing to the COB, to be auctioned for price improvement through an automated request for response auction process, subject to certain conditions.<sup>153</sup> C2’s complex order execution rule is based on CBOE’s rule.<sup>154</sup>

Finally, C2 has proposed a rule prohibiting trading on knowledge of imminent undisclosed solicited transactions, otherwise known as the “anticipatory hedge” rule.<sup>155</sup> Pursuant to this rule, it will be considered conduct inconsistent with just and equitable principles of trade and a violation of Rule 4.1 for any Participant or person associated with a Participant, who has knowledge of all material terms and conditions of an original order and a solicited order, including a facilitation order, that matches the original order’s limit, the execution of which are imminent, to enter, based on such knowledge, an order to buy or sell an option of the same class as an option that is the subject of the original order, or an order to buy or sell the security underlying such class, or an order to buy or sell any related instrument until either (i) all the terms and conditions of the original order and any changes in the terms and conditions of the original order of which that member or associated person has knowledge are disclosed to the trading crowd or (ii) the solicited trade can no longer reasonably be considered imminent in view of the passage of time since the solicitation.

For the reasons discussed above, the Commission believes that C2’s proposed display, execution, and priority rules

<sup>152</sup> See C2 Rule 6.13(b). See also C2 Rule 6.12(g) and Amendment No. 1 (regarding complex order priority). Orders entered by any C2 market participant also may rest in the COB.

<sup>153</sup> See C2 Rule 6.13(c). See also C2 Rule 6.12(g) and Amendment No. 1 (a complex order may be executed at a net debit or credit price without giving priority to equivalent bids (offers) in the individual series legs that are represented in the System provided at least one leg of the order betters the best corresponding public customer bid (offer) in the system by at least one minimum trading increment or, if COB or COA are activated for all market participants in the subject option class, a \$0.01 increment to be determined by C2 on a class-by-class basis); and C2 Rule 4.18 (prohibiting the misuse of material, nonpublic information as such would be applicable in the context of preventing the disclosure of nonpublic information about a complex order auction).

<sup>154</sup> See CBOE Rule 6.53C. As on CBOE, on C2, a member seeking to trade with its customer’s complex order would be required to comply with C2 Rule 6.50(a), and a member seeking to cross its customer’s complex order with solicited orders would be required to comply with C2 Rule 6.50(b). In addition, the complex order priority provision in C2 Rule 6.12(g) will apply to complex orders.

<sup>155</sup> See C2 Rule 6.55. See also Amendment No. 1 (containing the proposed rule).

are consistent with the Act. In particular, the Commission finds that the proposed rules are consistent with Section 6(b)(5) of the Act,<sup>156</sup> which, among other things, requires that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest, and to not permit unfair discrimination between customers, issuers, or dealers. The Commission also finds that the proposed rules are consistent with Section 6(b)(8) of the Act,<sup>157</sup> which requires that the rules of an exchange not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. In particular, the Commission believes that the proposed matching mechanisms should facilitate the prompt execution of orders, while providing Participants with an opportunity to compete for exposed bids and offers.<sup>158</sup>

## 2. Opening

C2 will employ an opening process that is designed to match the greatest number of pending buy and sell orders.<sup>159</sup> Prior to opening a series, C2 will make available to all Participants the expected opening price and size, which should help attract additional orders that, in turn, could offset any imbalances at the open.<sup>160</sup> After the start of trading in the underlying security, the Exchange will open each series at a price that executes the greatest amount of pre-opening interest and that does not trade-through the NBBO (if one exists).<sup>161</sup> The Commission believes that C2's opening rules are designed to conduct the opening on C2 in a fair and orderly fashion and are consistent with the Act.

## 3. Obvious and Catastrophic Errors

C2 proposed an obvious and catastrophic error rule based on the corresponding rule of the International Securities Exchange, LLC.<sup>162</sup> The

Commission believes that in most circumstances trades that are executed between parties should be honored. On rare occasions, the price of the executed trade indicates an "obvious" or "catastrophic" error may exist, suggesting that it is unlikely that the parties to the trade had come to a meeting of the minds regarding the terms of the transaction. In the Commission's view, the determination of whether an error has occurred should be based on specific and objective criteria and subject to specific and objective procedures.<sup>163</sup> The Commission believes that C2's proposed obvious error rule provides clear and objective standards and procedures for determining whether an obvious error has occurred, is consistent with the Act, and is substantively the same as obvious error rules previously approved by the Commission for other exchanges.<sup>164</sup>

### 4. Section 11(a) of the Act

Section 11(a)(1) of the Act<sup>165</sup> prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion (collectively, "covered accounts") unless an exception applies. Rule 11a2-2(T) under the Act,<sup>166</sup> known as the "effect versus execute" rule, provides exchange members with an exemption from the Section 11(a)(1) prohibition. Rule 11a2-2(T) permits an exchange member, subject to certain conditions, to effect transactions for covered accounts by arranging for an unaffiliated member to execute transactions on the exchange. To comply with Rule 11a2-2(T)(a)(2)'s conditions, a member: (i) May not be affiliated with the executing member;

respect to no bid series, C2's rule provides that transactions in series quoted no bid and \$0.05 or less offer can be nullified provided, among other things, that at least one strike price below (for calls) or above (for puts) in the same options class was quoted zero bid and \$0.05 or less offer at the time of execution. ISE Rule 720 requires two such strikes below (for calls) or above (for puts). See Securities Exchange Act Release No. 59548 (March 10, 2009), 74 FR 11147 (March 16, 2009) (File No. SR-ISE-2009-10) (notice of filing and immediate effectiveness of proposed rule change to amend ISE's obvious error rule). C2's rule is similar to NYSE Arca Rule 6.87 (Obvious Errors and Catastrophic Errors) in that it only provides for one strike. See also CBOE Rule 6.25 (Nullification and Adjustment of Equity Options Transactions).

<sup>163</sup> See NOM Approval Order, *supra* note 92, at 73 FR 14532.

<sup>164</sup> See, e.g., Securities Exchange Act Release No. 57398 (February 28, 2008), 73 FR 12240 (March 6, 2008) (File No. SR-ISE-2007-112) (order approving amendments to ISE Rule 720).

<sup>165</sup> 15 U.S.C. 78k(a)(1).

<sup>166</sup> 17 CFR 240.11a2-2(T).

(ii) must transmit the order from off the exchange floor; (iii) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution;<sup>167</sup> and (iv) with respect to an account over which the member has investment discretion, neither the member nor its associated person may retain any compensation in connection with effecting the transaction except as provided in the Rule.

In a letter to the Commission, C2 requests that the Commission concur with C2's conclusion that Participants that enter orders into C2 satisfy the requirements of Rule 11a2-2(T).<sup>168</sup> For the reasons set forth below, the Commission believes that Participants entering orders into C2 would satisfy the conditions of the Rule.

The Rule's first condition is that the order be executed by an exchange member who is unaffiliated with the member initiating the order.<sup>169</sup> The Commission has stated that this requirement is satisfied when automated exchange facilities, such as the C2 system, are used, as long as the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange.<sup>170</sup> C2 has represented that the design of the C2 system ensures that no member has any special or unique trading advantage in the handling of its orders after transmitting its orders to C2.<sup>171</sup> Based on C2's representation, the Commission believes that the C2 system satisfies this requirement.

Second, the Rule requires that orders for covered accounts be transmitted from off the exchange floor.<sup>172</sup> The C2 system receives orders electronically through remote terminals or computer-

<sup>167</sup> The member may, however, participate in clearing and settling the transaction. See 1978 Release, *infra* note 173.

<sup>168</sup> See Letter from Angelo Evangelou, Assistant General Counsel, CBOE, to Elizabeth King, Associate Director, Division of Trading and Markets, Commission, dated October 16, 2009 ("C2 11(a) Letter").

<sup>169</sup> 17 CFR 240.11a2-2(T)(a)(2)(i).

<sup>170</sup> See, e.g., NOM Approval Order, *supra* note 92, at note 269 (citing to the 1979 Release). In considering the operation of automated execution systems operated by an exchange, the Commission noted that while there is not an independent executing exchange member, the execution of an order is automatic once it has been transmitted into the systems. Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange, the Commission has stated that executions obtained through these systems satisfy the independent execution requirement of Rule 11a2-2(T). See 1979 Release, *infra* note 173.

<sup>171</sup> See C2 11(a) Letter, *supra* note 168.

<sup>172</sup> 17 CFR 240.11a2-2(T)(a)(2)(ii).

<sup>156</sup> 15 U.S.C. 78f(b)(5).

<sup>157</sup> 15 U.S.C. 78f(b)(8).

<sup>158</sup> See, e.g., Securities Exchange Act Release No. 58088 (July 2, 2008), 73 FR 39747 (July 10, 2008) (File No. CBOE-2008-16) (order approving a proposal to reduce certain order exposure times).

<sup>159</sup> C2 will accept pre-opening orders. See C2 Rule 6.11(a).

<sup>160</sup> See C2 Rule 6.11(a) and Amendment No. 1.

<sup>161</sup> See C2 Rule 6.11.

<sup>162</sup> See C2 Rule 6.15 and Amendment No. 1. See also International Stock Exchange Rule 720. With

to-computer interfaces. In the context of other automated trading systems, the Commission has found that the off-floor transmission requirement is met if a covered account order is transmitted from a remote location directly to an exchange's floor by electronic means.<sup>173</sup> Because the C2 system receives orders electronically through remote terminals or computer-to-computer interfaces, the Commission believes that the C2 system satisfies the off-floor transmission requirement.<sup>174</sup>

Third, the Rule requires that the member not participate in the execution of its order.<sup>175</sup> C2 represented that at no time following the submission of an order is a Participant able to acquire control or influence over the result or timing of an order's execution. According to C2, the execution of a member's order is determined solely by what other orders, bids, or offers are present in the C2 system at the time the Participant submits the order and on the priority of those orders, bids, and offers.<sup>176</sup> Based on these representations, the Commission believes that a Participant does not

participate in the execution of an order submitted to the C2 system.

Fourth, in the case of a transaction effected for an account with respect to which the initiating member or an associated person thereof exercises investment discretion, neither the initiating member nor any associated person thereof may retain any compensation in connection with effecting the transaction, unless the person authorized to transact business for the account has expressly provided otherwise by written contract referring to Section 11(a) of the Act and Rule 11a2-2(T).<sup>177</sup> Participants trading for covered accounts over which they exercise investment discretion must comply with this condition in order to rely on the rule's exemption.<sup>178</sup>

#### E. Listing Procedures

C2 will incorporate by reference CBOE's listing rules for options.<sup>179</sup> As such, the Commission finds that C2's proposed initial and continued listing rules, which are based on CBOE rules previously approved by the Commission, are consistent with the Act, including Section 6(b)(5), in that they are designed to protect investors and the public interest and to promote just and equitable principles of trade. The Commission notes that, before beginning operation, C2 will need to become a participant in the Plan for the Purpose of Developing and Implementing Procedures Designed to Facilitate the Listing and Trading of Standardized Options Submitted Pursuant to Section 11A(a)(3)(B) of the Securities Exchange Act of 1934 ("OLPP"). In addition, before beginning operation, C2 will need to become a participant in the Options Clearing Corporation.

<sup>177</sup> 17 CFR 240.11a2-2(T)(a)(2)(iv). In addition, Rule 11a2-2(T)(d) requires a member or associated person authorized by written contract to retain compensation, in connection with effecting transactions for covered accounts over which such member or associated persons thereof exercises investment discretion, to furnish at least annually to the person authorized to transact business for the account a statement setting forth the total amount of compensation retained by the member in connection with effecting transactions for the account during the period covered by the statement. See 17 CFR 240.11a2-2(T)(d). See also 1978 Release, *supra* note 173 (stating "[t]he contractual and disclosure requirements are designed to assure that accounts electing to permit transaction-related compensation do so only after deciding that such arrangements are suitable to their interests.").

<sup>178</sup> See C2 11(a) Letter, *supra* note 168.

<sup>179</sup> See *infra* Section IV (discussing an exemption from Section 19(b) of the Act for CBOE rules incorporated by reference by C2). See also C2 Rules Chapter 5.

#### IV. Exemption From Section 19(b) of the Act With Regard to CBOE Rules Incorporated by Reference

C2 proposes to incorporate by reference certain CBOE rules as C2 rules, including Chapters 4 (Business Conduct), 5 (Securities Dealt In), 6 Section E (Intermarket Linkage), 9 (Doing Business with the Public), 10 (Closing Transactions), 11 (Exercises and Deliveries), 12 (Margins), 13 (Net Capital Requirements), 15 (Records, Reports and Audits), 16 (Summary Suspension by Chairman of the Board or Vice Chairman of the Board), 17 (Discipline), 18 (Arbitration), 19 (Hearings and Review), and 24 (Index Options). In each Chapter including incorporated rules, C2 states that these such rules "as such rules may be in effect from time to time, shall apply to C2 and are hereby incorporated into this Chapter" and that C2 members shall comply with a C2 rule by complying with the CBOE rules incorporated by reference "as if such rules were part of the C2 Rules."<sup>180</sup> In connection with its proposal to incorporate certain CBOE rules by reference, C2 requested, pursuant to Rule 0-12,<sup>181</sup> an exemption under Section 36 of the Act<sup>182</sup> from the rule filing requirements of Section 19(b) of the Act for changes to those C2 rules that are affected solely by virtue of a change to a cross-referenced CBOE rule. C2 proposes to incorporate by reference categories of rules (rather than individual rules within a category) that are not trading rules. C2 also agrees to provide written notice to its members whenever CBOE proposes a rule change to a CBOE rule that C2 has incorporated by reference.<sup>183</sup>

Using its authority under Section 36 of the Act, the Commission previously exempted several other SROs from the requirement to file proposed rule changes under Section 19(b) of the Act.<sup>184</sup> Each such exempt SRO agreed to be governed by the incorporated rules, as amended from time to time, but is not required to file a separate proposed rule

<sup>180</sup> See, e.g., C2 Rules Chapter 4 (Business Conduct).

<sup>181</sup> See 17 CFR 240.0-12.

<sup>182</sup> 15 U.S.C. 78mm.

<sup>183</sup> See Letter from Angelo Evangelou, Assistant General Counsel, CBOE, to Elizabeth M. Murphy, Secretary, Commission, dated October 16, 2009.

<sup>184</sup> See, e.g., Securities Exchange Act Release No. 49260 (February 17, 2004), 69 FR 8500 (February 24, 2004) (order granting application for exemptions pursuant to Section 36(a) of the Act by the American Stock Exchange LLC, the International Securities Exchange, Inc., the Municipal Securities Rulemaking Board, the Pacific Exchange, Inc., the Philadelphia Stock Exchange, Inc., and the Boston Stock Exchange, Inc.); and Nasdaq Exchange Registration Order, *supra* note 39, at 71 FR 3565-66.

<sup>173</sup> See, e.g., NOM Approval Order, *supra* note 92, at 73 FR 14538; Nasdaq Exchange Registration Order, *supra* note 39, at 71 FR 3560; and Securities Exchange Act Release Nos. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (File No. SR-BSE-2002-15) (order approving the rules of the Boston Options Exchange); 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001) (File No. SR-PCX-00-25) (order approving the Archipelago Exchange as an electronic trading facility of the Pacific Exchange ("PCX")); 29237 (May 24, 1991), 56 FR 24853 (May 31, 1991) (File Nos. SR-NYSE-90-52 SR-NYSE-90-53) (regarding NYSE's Off-Hours Trading Facility); 15533 (January 29, 1979), 44 FR 6084 (January 31, 1979) (File No. S7-163) (regarding the American Stock Exchange Post Execution Reporting System, the Amex Switching System, the Intermarket Trading System, the Multiple Dealer Trading Facility of the Cincinnati Stock Exchange, the PCX Communications and Execution System, and the Philadelphia Stock Exchange's Automated Communications and Execution System ("1979 Release")); and 14563 (March 14, 1978) 43 FR 11542 (March 17, 1978) (File No. S7-163) (regarding the NYSE's Designated Order Turnaround System ("1978 Release")).

<sup>174</sup> See, e.g., NOM Approval Order, *supra* note 92, at 73 FR 14538-39.

<sup>175</sup> 17 CFR 240.11a2-2(T)(a)(iii).

<sup>176</sup> See C2 11(a) Letter, *supra* note 168. The Participant may cancel or modify the order, or modify the instruction for executing the order, but only from off the floor. The Commission has stated that the non-participation requirement is satisfied under such circumstances so long as such modifications or cancellations are also transmitted from off the floor. See 1978 Release, *supra* note 173 (stating that the "non-participation requirement does not prevent initiating members from canceling or modifying orders (or the instructions pursuant to which the initiating member wishes orders to be executed) after the orders have been transmitted to the executing member, provided that any such instructions are also transmitted from off the floor").

change with the Commission each time the SRO whose rules are incorporated by reference seeks to modify its rules. In addition, each such exempt SRO incorporated by reference only regulatory rules (*i.e.*, margin, suitability, arbitration), not trading rules, and incorporated by reference whole categories of rules. Each such exempt SRO had reasonable procedures in place to provide written notice to its members each time a change is proposed to the incorporated rules of another SRO in order to provide its members with notice of a proposed rule change that affects their interests, so that they would have an opportunity to comment on it.

The Commission is granting C2's request for exemption, pursuant to Section 36 of the Act, from the rule filing requirements of Section 19(b) of the Act with respect to the rules that C2 proposes to incorporate by reference. This exemption is conditioned upon C2 providing written notice to its members whenever CBOE proposes to change a rule that C2 has incorporated by reference. The Commission believes that this exemption is appropriate in the public interest and consistent with the protection of investors because it will promote more efficient use of Commission and SRO resources by avoiding duplicative rule filings based on simultaneous changes to identical rules sought by more than one SRO. Consequently, the Commission grants C2's exemption request.

## V. Conclusion

*It is ordered* that the application of C2 for registration as a national securities exchange be, and hereby is, granted.

*It is further ordered* that operation of C2 is conditioned on the satisfaction of the following requirements:

A. *Participation in National Market System Plans Relating to Options Trading.* C2 must join: (1) The Plan for the Reporting of Consolidated Options Last Sale Reports and Quotation Information (*i.e.*, the Options Price Reporting Authority); (2) the OLPP; (3) the Linkage Plan;<sup>185</sup> and (4) the Plan of the Options Regulatory Surveillance Authority.

B. *Participation in Multiparty 17d-2 Plans.* C2 must become a party to the multiparty 17d-2 agreements concerning sales practice regulation and market surveillance.<sup>186</sup>

C. *Participation in the Options Clearing Corporation.* C2 must join the Options Clearing Corporation.

D. *Participation in the Intermarket Surveillance Group.* C2 must join the Intermarket Surveillance Group.

E. *Examination by the Commission.* C2 must have, and represent in a letter to the staff in the Commission's Office of Compliance Inspections and Examinations that it has, adequate procedures and programs in place to effectively regulate C2.

*It is further ordered*, pursuant to Section 36 of the Act,<sup>187</sup> that C2 shall be exempt from the rule filing requirements of Section 19(b) of the Act<sup>188</sup> with respect to the CBOE rules C2 proposes to incorporate by reference into C2's rules, subject to the conditions specified in this Order.

By the Commission.

Elizabeth M. Murphy,

Secretary.

[FR Doc. E9-29877 Filed 12-15-09; 8:45 am]

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. IA-2959; File No. S7-29-09]

### Approval of Investment Adviser Registration Depository Filing Fees

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Order; request for comment.

**SUMMARY:** The Securities and Exchange Commission ("Commission" or "SEC") is, for one year, reducing Investment Adviser Registration Depository annual and initial filing fees that will be charged beginning January 1, 2010 through December 31, 2010.

**DATES:** *Effective Date:* The order will become effective on January 1, 2010.

*Comment Due Date:* Comments should be received on or before February 1, 2010.

**ADDRESSES:** Comments may be submitted by any of the following methods:

#### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/other.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-29-09 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.

<sup>187</sup> 15 U.S.C. 78mm.

<sup>188</sup> 15 U.S.C. 78s(b).

All submissions should refer to File Number S7-29-09. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/other.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Keith Kanyan, IARD System Manager, at 202-551-6737, or [Iarules@sec.gov](mailto:Iarules@sec.gov), Office of Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-8549.

**SUPPLEMENTARY INFORMATION:** Section 204(b) of the Investment Advisers Act of 1940 ("Advisers Act") authorizes the Commission to require investment advisers to file applications and other documents through an entity designated by the Commission, and to pay reasonable costs associated with such filings.<sup>1</sup> In 2000, the Commission designated the Financial Industry Regulatory Authority Regulation, Inc. ("FINRA") as the operator of the Investment Adviser Registration Depository ("IARD") system. At the same time, the Commission approved, as reasonable, filing fees.<sup>2</sup> The Commission later required advisers registered or registering with the SEC to file Form ADV through the IARD.<sup>3</sup> Over 11,000 advisers now use the IARD to register with the SEC and make state notice filings electronically through the Internet.

Commission staff, representatives of the North American Securities Administrators Association, Inc. ("NASAA"),<sup>4</sup> and representatives of

<sup>1</sup> 15 U.S.C. 80b-4(b).

<sup>2</sup> Designation of NASD Regulation, Inc., to Establish and Maintain the Investment Adviser Registration Depository; Approval of IARD Fees, Investment Advisers Act Release No. 1888 (July 28, 2000) [65 FR 47807 (Aug. 3, 2000)]. FINRA was formerly known as NASD.

<sup>3</sup> Electronic Filing by Investment Advisers; Amendments to Form ADV, Investment Advisers Act Release No. 1897 (Sept. 12, 2000) [65 FR 57438 (Sept. 22, 2000)].

<sup>4</sup> The IARD system is used by both advisers registering or registered with the SEC and advisers

<sup>185</sup> See Linkage Plan, *supra* note 78.

<sup>186</sup> See *supra* note 111 (citing to the most recent versions of the two plans). See also *infra* Section III.C.3 (Multiparty 17d-2 Agreements); and 17 CFR 240.17d-2.