

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-65371; File No. SR-C2-2011-021)

September 21, 2011

Self-Regulatory Organizations; C2 Options Exchange, Incorporated; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Related to the Exchange's Automated Improvement Mechanism

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on September 16, 2011, the C2 Options Exchange, Incorporated ("Exchange" or "C2") filed with the Securities and Exchange Commission (the "Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Exchange has designated the proposal as a "non-controversial" proposed rule change pursuant to Section 19(b)(3)(A)(iii) of the Act³ and Rule 19b-4(f)(6) thereunder.⁴ The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Exchange proposes to amend C2 Rule 6.51, Automated Improvement Mechanism ("AIM"). The text of the proposed rule change is available on the Exchange's website (<http://www.c2exchange.com/Legal/RuleFilings.aspx>), at the Exchange's Office of the Secretary and at the Commission's Public Reference Room.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A)(iii).

⁴ 17 CFR 240.19b-4(f)(6).

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

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

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

1. Purpose

C2 Rule 6.51 governs the operation of an Exchange feature that allows agency orders to electronically execute against principal or solicited interest pursuant to a crossing entitlement after being exposed in an auction (referred to as “AIM”). The purpose of this proposed rule change is to incorporate a provision into the rule that would provide the Exchange with the ability to determine to apply a price-time priority allocation algorithm for the SPXPM option class,⁵ subject to certain conditions.

Currently, Rule 6.51(b)(3) specifies that agency orders may be allocated via AIM at the best price(s) pursuant to the allocation algorithm in effect for the class, subject to various conditions set forth in subparagraphs (b)(3)(A) through (I), including a requirement that public customer orders in the book shall have priority over the crossing entitlement. As proposed, the rule change would provide the Exchange with the flexibility to permit the allocation algorithm in effect for AIM in the SPXPM option class to be the price-time priority allocation algorithm (as

⁵ SPXPM is the ticker symbol for the P.M.-settled S&P 500 Index options to be listed and traded on C2. See Securities Exchange Act Release No. 65256 (September 2, 2011)(SR-C2-2011-008).

provided in Rule 6.12, Order Execution and Priority) even if the allocation algorithm in effect for intra-day trading in the class is some other allocation algorithm.⁶ If a determination is made to use price-time priority for AIM in the SPXPM option class, allocations would still be subject to the various conditions set forth in subparagraphs (b)(3)(A) through (I) of Rule 6.51, including the requirements that public customer orders in the book have priority over the crossing entitlement and that the crossing entitlement generally be limited to 40% (as specified in more detail in Rule 6.51). All pronouncements regarding allocation algorithm determinations by the Exchange for AIM in SPXPM will be announced to C2 Trading Permit Holders via Regulatory Circular.

As noted above, the price-time priority allocation algorithm that would be applied to AIM for the SPXPM option class is one of the algorithms specified in Rule 6.12. Thus, the Exchange is not creating any new algorithm for the AIM mechanism with respect to SPXPM, but is amending Rule 6.51 to provide the flexibility to choose the price-time priority allocation algorithm for AIM in the SPXPM option class rather than simply defaulting to the algorithm that will be in effect for intra-day trading in the SPXPM options class (e.g., the algorithm for intra-day trading in SPXPM may be established as pro-rata priority (without public customer priority)), while the algorithm for AIM may be established as price-time priority (subject to certain conditions set out in the AIM rule, including the requirement that public customers have priority over the crossing entitlement). All other aspects of AIM, pursuant to Rule 6.51, shall apply unchanged.⁷

⁶ The allocation algorithms include price-time priority, pro-rata priority, and price-time with primary public customer and secondary trade participation right priority. Each of these base allocation methodologies can be supplemented with an optional market turner priority overlay. See Rule 6.12(a) through (b).

⁷ In connection with this change, the Exchange is also proposing a non-substantive amendment to Rule 6.51. Specifically, the Exchange is proposing to replace the term “matching algorithm” with “allocation algorithm” so there is consistency in the use of

Having this additional flexibility will allow the Exchange to select the price-time priority allocation algorithm for AIM in the SPXPM option class (which algorithm is included among the existing algorithms set forth in Rule 6.12) even when a different allocation algorithm may be in effect for intra-day trading in the SPXPM option class. The Exchange notes that public customer orders are not impacted by this proposed rule change because, as discussed above, public customer priority is one of the conditions of the AIM auction that does not change regardless of on the base allocation algorithm that is applicable for the class. Thus, regardless of the base allocation algorithm in effect for intra-day trading and AIM in the class (e.g., price-time priority or pro-rata priority), public customer orders in the book have priority to execute before any crossing entitlement is applied or any remaining balance after the application of the entitlement is allocated pursuant to the base algorithm.⁸ For example:

- Under the current rules, the Exchange may determine to apply a pro-rata allocation algorithm (without public customer priority) for intra-day trading in SPXPM, in which case the AIM allocation algorithm for SPXPM would be public customer priority, then the crossing entitlement, then any remaining balance allocated based on

terms within the rules. See proposed changes to Rule 6.51(b)(3).

⁸ To the extent that public customers may strategically rest orders based on the allocation algorithm employed for intra-day and auction trading on a given exchange, public customers can (and already would today under the existing rules) adjust their “quoting” behavior accordingly, similar to how they and other market participants already would do today. Several market characteristics factor into a market participant’s quoting behavior including, but certainly not limited to, the applicable fee structure, average incoming order size, and the average touch rate (i.e., average allocation a market participant actually receives on incoming electronic orders). The allocation for any market participant (including public customers) changes constantly from order-to-order, second-to-second for various reasons. The ultimate allocation depends upon, among other things, the size of an incoming order and whatever trading interest happens to be represented at the time the order is received. The Exchange believes (and as is further illustrated above) that the instant proposed rule change presents nothing novel or unique in this respect.

pro-rata priority.

- Under the proposed rule change, the Exchange may determine to apply a pro-rata allocation algorithm (without public customer priority) for intra-day trading in SPXPM and a price-time allocation for AIM in SPXPM, in which case the AIM allocation algorithm would be public customer priority, then the crossing entitlement, then any remaining balance allocated based on pro-rata priority.

Public customer orders have the same experience under both allocation scenarios noted above.

To further illustrate this point, consider the following examples:

- Under the current rules, the intra-day allocation algorithm in effect for SPXPM is pro-rata. If there are three public customer orders to sell resting in the book (each for 10 contracts at \$1.20) and an agency order for 100 contracts is presented for crossing via AIM and the execution price at the conclusion of the auction is \$1.20 (assume there are no responses and no other interest represented on the book at \$1.20), the priority would be 10 contracts to each resting public customer order, then the remaining balance of 70 contracts is allocated to the crossing contra-order.
- Under the proposed rule change, if the intra-day allocation algorithm in effect for SPXPM is pro-rata and for AIM in SPXPM is price-time, the outcomes would be exactly the same. Specifically, if there are three public customer orders to sell resting in the book (each for 10 contracts at \$1.20) and an agency order for 100 contracts is presented for crossing via AIM and the execution price at the conclusion of the auction is \$1.20 (assume there are no responses and no other interest represented on the book at \$1.20), the priority would be 10 contracts to each resting public customer order, then the remaining balance of 70 contracts is allocated to the crossing contra-

order.

The Exchange also believes that having the ability to select price-time priority as an alternate algorithm for SPXPM will provide us with additional flexibility to incent market participants to respond to AIM auctions. The Exchange believes that the proposed rule change would encourage quote competition because it is designed to reward aggressive pricing by offering incentives for Market-Makers and other market participants to support and participate in AIM and for market participants to establish the best price. When a price-time base algorithm is utilized for AIM, all market participants (including public customers) are incented to compete by establishing the best price.

The Exchange also notes that the outcomes that would result from the selection of the price-time priority algorithm for AIM are not novel or unique. Each outcome is an allocation that is currently permitted under C2's existing allocation rule, Rule 6.12. (Under the current rules, the Exchange could select price-time for the intra-day algorithm in SPXPM and, thus, the allocation algorithm for AIM would be public customer priority, then the crossing entitlement, then the remainder allocated based on price-time priority.) The Exchange further notes the fact that an order may be subject to one allocation under the intraday automatic execution procedures and another allocation under AIM is not novel or unique. The allocation algorithms for various mechanisms and trading scenarios on C2 (and on other exchanges) already have allocation algorithms "hardcoded" into the rules that differ from the intra-day allocation algorithms.⁹ In each instance, a resting order is subject to varying allocations depending on several factors. In fact, as discussed and illustrated above, AIM currently has an allocation algorithm hardcoded into the C2 rules that differs from the intra-day allocation algorithm. As illustrated above, it is

⁹ See, e.g., C2 Rules 6.51 and 6.52 and Chicago Board Options Exchange, Incorporated Rules 6.74A and 6.74B.

already possible today for a simple resting public customer order to receive a pro-rata share if executed intra-day, and a public customer priority share if executed via AIM.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act¹⁰ and the rules thereunder, and in particular with: Section 6(b)(5) of the Act, which requires that the rules of a national securities exchange, among other things, be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest; and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers;¹¹ and Section 6(b)(8) of the Act, which requires the rules of an exchange not to impose any burden on competition not necessary or in furtherance of the Act.¹² The Exchange believes the proposed rule change is consistent with the Act in so much as use of a price-time priority allocation algorithm for AIM in SPXPM is consistent with, and already permitted under, C2 rules. The Exchange further notes that the proposed rule change ensures that incoming electronic orders processed through AIM are allocated in an equitable and fair manner and that market participants (including public customers) have a fair and reasonable opportunity for allocations based on established criteria and procedures. In this regard, the Exchange notes that public customer orders are not impacted by this proposed rule change because, as discussed above, public customer priority is one of the conditions of the AIM auction that does not change regardless of on the base allocation algorithm that is applicable for the class. The Exchange also believes that the change will allow the Exchange another method to

¹⁰ 15 U.S.C. 78f(b).

¹¹ 15 U.S.C. 78f(b)(5).

¹² 15 U.S.C. 78f(b)(8).

reward aggressive pricing in AIM for the SPXPM options class. The Exchange believes that use of a price-time priority allocation algorithm in AIM (which is already an approved allocation algorithm utilized by the Exchange) would encourage quote competition because is designed to reward aggressive pricing by offering incentives both for Market-Makers and other market participants to support and participate in the C2 marketplace and for market participants to establish the best price. When a price-time algorithm is utilized in AIM, market participants (including public customers) are incented to compete by establishing the best price.

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

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

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

The Exchange neither solicited nor received comments on the proposal.

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

Because the foregoing rule does not (i) significantly affect the protection of investors or the public interest; (ii) impose any significant burden on competition; and (iii) become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest, provided that the self-regulatory organization has given the Commission written notice of its intent to file the proposed rule change at least five business days prior to the date of filing of the proposed rule change or such shorter time as designated by the Commission, the proposed rule change has become effective pursuant to Section 19(b)(3)(A) of the Act¹³ and Rule 19b-4(f)(6) thereunder.¹⁴ At any time within 60 days of

¹³ 15 U.S.C. 78s(b)(3)(A).

¹⁴ 17 CFR 240.19b-4(f)(6).

the filing of such proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. Solicitation of Comments

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

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-C2-2011-021 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-C2-2011-021. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be

available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of C2. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available. All submissions should refer to File Number SR-C2-2011-021 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁵

Elizabeth M. Murphy
Secretary

¹⁵ 17 CFR 200.30-3(a)(12).