

## OMB APPROVAL

OMB Number: 3235-0045  
 Estimated average burden  
 hours per response.....38

Required fields are shown with yellow backgrounds and asterisks.

Page 1 of \* 14

SECURITIES AND EXCHANGE COMMISSION  
 WASHINGTON, D.C. 20549  
 Form 19b-4

File No. \* SR - 2013 - \* 013

Amendment No. (req. for Amendments \*) 1

Filing by C2 Options Exchange, Incorporated

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial \*

☐

Amendment \*

☒

Withdrawal

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Section 19(b)(2) \*

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Section 19(b)(3)(A) \*

☐

Section 19(b)(3)(B) \*

☐

Rule

Pilot

☐

Extension of Time Period  
for Commission Action \*

☐

Date Expires \*

☐ 19b-4(f)(1)

☐ 19b-4(f)(4)

☐ 19b-4(f)(2)

☐ 19b-4(f)(5)

☐ 19b-4(f)(3)

☐ 19b-4(f)(6)

Notice of proposed change pursuant to the Payment, Clearing, and Settlement Act of 2010

Section 806(e)(1)

☐

Section 806(e)(2)

☐

Security-Based Swap Submission pursuant  
to the Securities Exchange Act of 1934

Section 3C(b)(2)

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Exhibit 2 Sent As Paper Document

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Exhibit 3 Sent As Paper Document

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## Description

Provide a brief description of the action (limit 250 characters, required when Initial is checked \*).

## Contact Information

Provide the name, telephone number, and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the action.

First Name \* Megan R.

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Title \* Attorney

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## Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

(Title \*)

Date 03/26/2013

By Megan R. Malone

(Name \*)

Attorney

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

Megan R. Malone, malone@cboe.com

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EDFS website.

**Form 19b-4 Information \***

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The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

**Exhibit 1 - Notice of Proposed Rule Change \***

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

**Exhibit 1A- Notice of Proposed Rule Change, Security-Based Swap Submission, or Advance Notice by Clearing Agencies**

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change, security-based swap submission, or advance notice being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

**Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications**

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Exhibit Sent As Paper Document

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Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

**Exhibit 3 - Form, Report, or Questionnaire**

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Exhibit Sent As Paper Document

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Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

**Exhibit 4 - Marked Copies**

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

**Exhibit 5 - Proposed Rule Text**

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The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

**Partial Amendment**

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If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

PARTIAL AMENDMENT

C2 Options Exchange, Incorporated (“C2” or the “Exchange”) submits this Amendment, constituting Amendment No. 1, to rule filing SR-C2-2013-013 in which the Exchange proposes to modify its rules to address certain option order handling procedures and quoting obligations on the Exchange after the implementation of the market wide equity Plan to Address Extraordinary Market Volatility. The purpose of this Amendment No. 1 is to provide a more explicit and descriptive rule text while providing a more robust accompanying purpose section. The Exchange is proposing to make the following modifications.

First, the Exchange is proposing to amend the rule text for proposed Rule 6.15.08 on page 5 of the 19b-4 and page 44 of the Exhibit 5. More specifically, the Exchange is proposing to delete the second, third, and fourth sentences in the original proposed text and replace them with the following sentences.

This shall also apply to Catastrophic Errors. In the interest of maintaining a fair and orderly market and for the protection of investors during a limit up-limit down state, the President of the Exchange or his/her designee, who shall be an officer of the Exchange but may not be a Permit Holder, may, on his or her own motion or upon request, determine to review any transition occurring on the Exchange during a limit up-limit down state that is believed to be erroneous. A transaction reviewed pursuant to this paragraph may be nullified or adjusted only if it is determined by the Exchange officer that the transaction is erroneous as provided in paragraphs (a)(1)-(3) of this Rule. A transaction would be adjusted or nullified in accordance with the provision under which it is deemed an erroneous transaction. The Exchange officer may be assisted by the Help Desk in

reviewing a transaction. The Exchange officer shall act as soon as possible after receiving the notification of the transaction, and ordinarily would be expected to act on the same day as the transaction occurred. In no event shall the Exchange officer act later than 8:30 a.m. (CT) on the next trading day following the date of the transaction at issue. This provision will be on a one year pilot basis following the adoption of this paragraph.

Next, the Exchange proposes to delete the last sentence of the first full paragraph on page 14 of the 19b-4 and the last sentence of the first paragraph on page 31 of the Exhibit 1 and replace it with the following sentence:

Because there is an uncertainty of market prices during a limit up-limit down state, terminating the HAL auction early and cancelling the market order will ensure that market orders do not receive an unanticipated price.

In addition, the Exchange proposes to replace the first full paragraph on page 16 through the first paragraph on page 17 of the 19b4 and replace the second full paragraph on page 32 through the first full paragraph on page 33 of the Exhibit 1 with the following paragraphs:

Because the theoretical price may be unreliable due to the underlying security entering a limit state, the Exchange is proposing to amend the Exchange obvious error rules to provide that the Exchange may not nullify or adjust trades when the underlying security is in a limit up-limit down state. The Exchange is also proposing to add language specifying that transactions in options that overlay a security that is in a limit up-limit down state may, however, be reviewed on an Exchange motion. More specifically, the Exchange is proposing to add language that states that in the interest of maintaining a fair and orderly market and for the protection of investors during a limit up-limit down state, the President

of the Exchange or his/her designee, who shall be an officer of the Exchange but may not be a Permit Holder, may, on his or her own motion or upon request, determine to review any transition occurring on the Exchange during a limit up-limit down state that is believed to be erroneous. A transaction reviewed pursuant to this paragraph may be nullified or adjusted only if it is determined by the Exchange officer that the transaction is erroneous as provided in Rule 6.15 (a)(1)-(3). A transaction would be adjusted or nullified in accordance with the provision under which it is deemed an erroneous transaction. The Exchange officer may be assisted by the Help Desk in reviewing a transaction. In addition, the Exchange officer shall act as soon as possible after receiving the notification of the transaction, and ordinarily would be expected to act on the same day as the transaction occurred. In no event shall the Exchange officer act later than 8:30 a.m. (CT) on the next trading day following the date of the transaction at issue. The Exchange is also proposing to add language to specify that this provision will be on a one year pilot basis following the adoption of this paragraph. The Exchange will provide the Commission with data and analysis during the duration of this pilot as requested.<sup>1</sup> The Exchange believes this will best protect the market because it allows limit orders to be executed on the Exchange while the underlying securities are in limit states regardless of the calculated theoretical price.

Another alternative, which the Exchange does not believe will be reliable, would be to maintain the current Exchange Rule 6.15. Pursuant to current rule 6.15(b)(1) Participants may have up to 15 minutes to review a transaction as an Obvious Error.

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<sup>1</sup> Finally, as an administrative change, the Exchange is proposing to eliminate a sentence referring to an Interpretation and Policy (.08) that no longer exists. The proposed provision will be the new Interpretation and Policy (.08) to Rule 6.15.

Pursuant to 6.15(d)(1), TPHs may have up to 7:30 am CT on the first trading day following a transaction to review it as a Catastrophic Error. The Exchange believes that during limit up-limit down states, the review period for transactions under the current Obvious Error and Catastrophic Error rules would allow Participants a second look at transactions that is potentially unfair to other market participants.

For example, a stock XYZ is trading in the \$20 range. The stock declines to a \$19 offer which initiates a limit up-limit down state. Assume a customer buys the XYZ OCT 15 call option when it is offered at \$4 during a limit up-limit down state. The stock does not come out of the state within 15 seconds which causes a trading pause. At the conclusion of the pause, XYZ re-opens at \$12, and the call is out of the money. C2 customer 1 is displeased with the call result and requests review under Rule 6.15. The review is requested, not because there was a true “obvious error,” but because an unfavorable trade was executed. Essentially, the customer gets a look back at executed trades and has nothing further to lose from such review. If the review is upheld, the seller of the options is harmed, and the customer gets the benefit. Conversely, if the stock trades after the limit up-limit down state and resumes trading in the \$20 range, the call will increase in value, and the customer has no reason to request the review.

This ability to challenge after seeing how the market moves may encourage unwanted behavior and may discourage market participants from providing liquidity knowing that trades could be challenged for reasons other than a true error. In this example, the seller completely bares the risk and may be discouraged from providing liquidity potentially creating further weakness in the options markets during an already stressed market condition. The Exchange believes that TPHs should not be able to benefit

from the time frame to review their transactions in these situations. The proposed change would help to ensure that limit orders entered during a limit up-limit down state would have certainty of execution.

The Exchange also believes that adding certainty to the execution of orders in these situations will encourage market participants to continue to provide liquidity to the Exchange and thus promote a fair and orderly market. Barring this change, the provisions of Rule 6.15(a)(3)(B) would likely apply in many instances during limit up-limit down states. This Rule provides that, the Theoretical Price of an option series is “if there are no quotes for comparison, as determined by designated personnel in the Help Desk.” The Exchange believes this provision would give rise to much uncertainty for TPHs as there is no bright line definition of what “theoretical value” should be for an option when the underlying NMS stock has an unexecutable bid or offer or both. Determining “theoretical value” in such a situation would be often times very subjective as opposed to an objective determination giving rise to additional uncertainty and confusion for investors.

Another example is if a \$500 security enters a straddle state resulting in un-executable bids and offers. Consequently the market for the options on that security widens to reflect the uncertainty surrounding what price the stock may be sold at to hedge the sale of puts or purchase of calls. Prior to entering the straddle state, the 22 day at the money \$500 strike put options were trading at \$24.45 - \$24.65.<sup>2</sup> Upon entering the straddle state, the market for those options widens to \$24.45 - \$35.00. A limit order to pay \$32 for 10 is entered resulting in a new market of \$32.00 - \$35.00. 14 seconds after

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<sup>2</sup> Calculated using a binomial pricing model for American style options with an interest rate of .25%, no dividends, and an implied volatility of 50.

entering the limit state in the underlying security, a limit order to sell 10 contracts at \$32 is received and trades with the posted \$32 limit order to buy. Immediately after the trade is consummated, the straddle state in the underlying security has not resolved and consequently the underlying security is halted.

Upon resumption of trading in the underlying security, consider two possible scenarios. In scenario one, the market for the security is \$450 - \$452. The puts which traded immediately prior to the trading halt are now worth at least their intrinsic value of \$50 and quite likely are trading with some time premium as well. The seller of 10 contracts at \$32 immediately requests an Obvious Error review under the provisions of Rule 6.15. In scenario two, the market for the security is now \$550 - \$552. The puts which traded immediately prior to the trading halt are now worth an estimated \$8.19.<sup>3</sup> The buyer of 10 contracts at \$32 immediately requests an Obvious Error review under the provisions of Rule 6.15.

Under both scenarios the bid/ask spread in the option was \$2 at the time of the trade and as such it now falls to a designated Trading Official to determine what the “theoretical value” of the option is. Absent the ability to ascertain prices at which the stock could have been bought or sold at the time the option traded, the designated Help Desk Personnel would be at best guessing what the “theoretical value” should have been. Such uncertainty in how the transaction will be resolved will only discourage participants from entering executable interest during limit up-limit down states. The impossibility of ascribing “theoretical value” to an option, whose price is directly affected by the ability to buy and

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<sup>3</sup> Id.



sell shares of the underlying security, gives rise to the Exchange need to make clear that trades during limit up-limit down states will stand irrespective of subsequent price moves in the underlying security. Absent this bright line guidance, the Exchange expects the entry of executable interest in the options market to be severely curtailed as securities approach and enter limit up-limit down states, decreasing the opportunity to foster price discovery and transparency at a time when it is most needed. In contrast, if Participants know in advance that trades they effect with quotes and/or orders having limit prices will stand irrespective of subsequent moves in the underlying security, they will be much more likely to submit such limit prices.

Another undesirable alternative for the Exchange would be to propose to always use the prevailing National Best Bid or Offer (“NBBO”) as the metric to decide whether an error has occurred, irrespective of how wide the NBBO was at the time of the execution. This approach alleviates the burden on the Exchange of having to ascribe a Theoretical Price creating an objective standard to an option when the stock has an un-executable bid, offer or both but it still presents significant problems. Though, in theory, using the NBBO would be an objective approach, because there is no reliable NBBO during a limit up-limit down state, this approach would often times be very subjective and give rise to uncertainty for market participants.

For example, in a limit up-limit down state, it is likely that there will be less depth of book – both on an intra as well as an intermarket basis. This gives rise to the potential for gaming of the Obvious Error Rule which mandates that Market-Maker to Market-Maker trades are always adjusted. For example, consider the following scenario.

Exchange	Bid Size	Bid Price	Ask Price	Ask Size
C2	50	\$5	\$7	1
CBOE	5	\$6	\$15	100

A CBOE Market-Maker is offering 100 contracts at \$15. Another CBOE Market-Maker enters an Intermarket Sweep Order (“ISO”) order to buy 100 contracts at \$15. Immediately after the execution the same CBOE Market-Maker requests a review under Rule 6.15. Simply using the NBBO, in this case \$7 would mean that, as required under Rule 6.15, the Exchange would rule to adjust that trade to \$7.30, essentially forcing the CBOE Market-Maker who was willing to provide liquidity at \$15 to instead provide liquidity at the much worse price of \$7.30. Such an outcome would undoubtedly result in fewer Market-Makers willing to post any liquidity for fear of this exact scenario. The Exchange notes that, if instead of a Market-Maker offering 100 contracts at \$15, it was a customer with a resting order in the Book the outcome of a review under Rule 6.15 would have been to bust the trade. The time permitted to request a review, conduct the review and issue notification to the affected parties can be substantial, particularly in light of a limit up-limit down state where the underlying security price is likely to be moving considerably. Essentially it would result in a customer selling options at \$15 which (for example) they had earlier bought earlier for \$10. Thus, the customer would end up an open position. Obviously, should the stock move adversely during the time taken to review the trade it is even possible for the option to be worth less than where the customer who was offering at \$15 purchased it. The Exchange strongly believes that certainty of trade during periods of market volatility is vital in order to operate a fair and orderly market.

Therefore, in lieu of these alternatives, the Exchange proposes to provide that the electronic transactions in options that occur during a limit up-limit down state would not be subject to review under Rule 6.15 for Obvious and Catastrophic Errors. The Exchange is also proposing to add text to give the Exchange authority to review transactions in the interest of maintaining a fair and orderly market and for the protection of investors, on its own motion, determine to review any transaction occurring on the Exchange that is believed to be erroneous that occurs during a limit up-limit down state.

The Exchange believes that this safeguard will provide the flexibility for the Exchange to act when necessary and appropriate to nullify or adjust a transaction, while also providing market participants with certainty that trades they effect with quotes and/or orders having limit prices will stand irrespective of subsequent moves in the underlying security. By limiting the erroneous trade review to only via Exchange motion, the Exchange believes that the proposal mitigates two of the undesirable aspects of the alternatives described above - (i) the moral hazard associated with granting a second look to trades that went against the market participant after market conditions have changed and (ii) gaming of the Obvious Error Rule to adjust Market-Makers - while also limiting the discretion of determining Theoretical Value to only those situations that the Exchange determines is necessary in the interest of maintaining a fair and orderly market and for the protection of investors.

The right to review on Exchange motion transactions that occur during a limit up-limit down state under this provision would also allow the Exchange to account for unforeseen circumstances that result in Obvious Errors such as technological or systems malfunctions of which a nullification or adjustment may be necessary in order to preserve

the interest of maintaining a fair and orderly market and for the protection of investors. Thus, the Exchange would be able to adjust or nullify truly erroneous transactions made on the Exchange during limit up-limit down states to protect the marketplace. By allowing the flexibility proposed, the Exchange can ensure that true errors are, in fact, handled in a fair way. Thus, the marketplace would continue to be protected in the event of some unforeseeable circumstance should arise. The Exchange, to the extent it exercises this provision, will do so within the Securities and Exchange Act of 1934 (the “Act”). In addition, the Exchange will create and maintain records demonstrating its authority to act pursuant to Rule 6.15(b)(3). Finally, if there is a request by a TPH to exercise this authority, the Exchange will record such requests, the circumstances surrounding such requests, the Exchange’s decision in the specific situation, and the final outcome.

In addition, the Exchange has committed to supplying the Commission data and analysis as requested. The Exchange will conduct its own analysis concerning the elimination of obvious error rules during limit and straddle states and agrees to provide the Commission with relevant data to assess the impact of this proposed rule change. As part of its analysis, the Exchange will evaluate (1) the options market quality during limit and straddle states, (2) assess the character of incoming order flow and transactions during limit and straddle states, and (3) review any complaints from members and their customers concerning executions during limit and straddle states. Additionally, the Exchange agrees to provide to the Commission data requested to evaluate the impact of the elimination of the obvious error rule, including data relevant to assessing the various analyses noted above.

The Exchange notes that there are additional protections in place outside of the

Obvious Error Rule, specifically pre-trade protections. More specifically, SEC Rule 15c3-5 requires that, “financial risk management controls and supervisory procedures must be reasonably designed to prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds, or that appear to be erroneous.”

Finally, the Exchange is proposing to add the following paragraphs after the first paragraph on page 23 of the 19b-4 and after the first full paragraph on page 38 of the Exhibit 1.

The Exchange further believes that it is necessary and appropriate in the interest of promoting fair and orderly markets to exclude transactions executed during a limit up-limit down state from certain aspects of the Exchange Rule 6.15. The Exchange believes the application of the current rule will be impracticable given the lack of a reliable NBBO in the options market during limit up-limit down states, and that the resulting actions (i.e., nullified trades or adjusted prices) may not be appropriate given market conditions. This change would ensure that limit orders that are filled during a limit up-limit down state would have certainty of execution in a manner that promotes just and equitable principles of trade, removes impediments to, and perfects the mechanism of a free and open market and a national market system.

Moreover, given that options prices during brief limit up-limit down states may deviate substantially from those available shortly following such states, the Exchange believes giving market participants time to reevaluate a transaction would create an unreasonable adverse selection opportunity that would discourage participants from providing liquidity during limit up-limit down states. In this respect, the Exchange notes that by rejecting market orders and not electing stop orders, only those orders with a limit

price will be executed during a limit up-limit down state. Therefore, on balance, the Exchange believes that removing the potential inequity of nullifying or adjusting executions occurring during limit up-limit down states outweighs any potential benefits from applying certain provisions during such unusual market conditions. Additionally, as discussed above, SEC Rule 15c3-5 provides additional pre-trade protections both within and outside of Rule 6.15 that will continue to safeguard customers.