

**RULE ENFORCEMENT REVIEW
OF THE
NEW YORK COTTON EXCHANGE**



**Division of Trading and Markets
September 26, 2001**

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RULE ENFORCEMENT REVIEW OF THE NEW YORK COTTON EXCHANGE

I. INTRODUCTION: PURPOSE AND SCOPE

The Division of Trading and Markets (“Division”) has completed a rule enforcement review of the trade practice surveillance and disciplinary programs of the New York Cotton Exchange (“NYCE”) for compliance with Sections 5a(a)(8) and 5a(b) of the Commodity Exchange Act (“Act”) and Commission Regulations 1.35 and 1.51.¹ The review covers the period of March 1, 2000 to March 1, 2001 (the “target period”).²

In conducting its review, Division staff examined Exchange documents that included, among others, computer reports generated by the Exchange’s automated trade practice surveillance system and other documentation used routinely in the conduct of trade practice surveillance; trade practice investigation and disciplinary logs; trade practice investigations and

¹ NYCE and its subsidiaries and divisions, the New York Futures Exchange (“NYFE”), the Financial Instrument Exchange (“FINEX”), and the Citrus Associates of the New York Cotton Exchange (“CITRUS”), (collectively referred to as the “Exchange”), all of which are included in this rule enforcement review, constitute Division B of the New York Board of Trade (“NYBOT”). NYBOT’s Coffee, Sugar & Cocoa Exchange (“CSCE”), which comprises NYBOT’s Division A, is not included in this review. The trade practice surveillance portion of the review includes an evaluation of the Exchange’s audit trail recordkeeping program.

² Since all but two months of the target period for this rule enforcement review concluded prior to enactment of the Commodity Futures Modernization Act of 2000 (“CFMA”), the Division conducted this review based on the requirements of the Act and Commission regulations existing during the target period, rather than on the basis of the core principles set forth in the CFMA.

Rule enforcement reviews prepared by the Division are intended to present an analysis of an exchange’s compliance capabilities for the period under review. Such reviews deal only with programs directly addressed in the review and do not assess all programs. The Division’s analyses, conclusions, and recommendations are based, in large part, upon the Division’s evaluation of a sample of investigatory cases and other exchange documents. This evaluation process, in some instances, identifies specific deficiencies in particular exchange investigations or methods but is not designed to uncover all instances in which an exchange does not address effectively all exchange rule violations or other deficiencies. Neither is such a review intended to go beyond the quality of the exchange’s self-regulatory systems to include direct surveillance of the market, although some direct testing is performed as a measure of quality control.

disciplinary action case files; minutes of disciplinary committee and Board of Director meetings held during the target period; and compliance manuals and guidelines. In addition, Division staff interviewed officials of the Exchange's Market Regulation Unit, including the Senior Vice President, Market Regulation; the Vice President, Compliance; and the Manager, Special Investigations.³

The Division gave the Exchange an opportunity to review and comment on a draft of this report on September 5, 2001. On September 6, 2001, Division staff conducted an exit conference with Exchange officials to discuss the report's findings and recommendations.

II. TRADE PRACTICE SURVEILLANCE

A. Staffing

The Exchange's trade practice surveillance is carried out by the NYBOT Compliance Department, which also conducts CSCE surveillance.⁴ In June 2000, the fourth month of the target period, NYBOT's new senior management reorganized NYBOT's self-regulatory operations by forming a new Market Regulation Unit, which includes NYBOT's Compliance Department, Market Surveillance Unit, and Market Statistics Unit.⁵ In conjunction with the restructuring, the Exchange hired a new Senior Vice President, Market Regulation, to head the Market Regulation Unit.⁶ The Market Regulation Unit is supported by NYBOT's Compliance

³ A copy of the transcript of the April 24, 2001 interview can be found in Appendix 1.

⁴ The Compliance Departments of NYCE and CSCE were merged in the June 1998 completion of the initial phase of the ongoing merger between CSCE and NYCE, which formed NYBOT. NYBOT is the parent company of NYCE and CSCE. The NYBOT Compliance Department also conducts trade practice surveillance and other self-regulatory oversight of the Cantor Financial Futures Exchange ("CX"), a wholly-owned subsidiary of NYCE, pursuant to a contract between NYCE and CX. *See* the Division's March 9, 2001 Rule Enforcement Review of the Cantor Financial Future Exchange for a description of NYBOT's role in overseeing CX trading activity.

⁵ A copy of the NYBOT Organizational Chart can be found in Appendix 2.

⁶ The Senior Vice President has 32 years of experience in futures regulation and compliance, including 15 years at the Commodity Exchange, Inc. ("Comex"), and a number of years on the staff of the Commission.

Attorney. The Compliance Attorney is responsible for overseeing the legal aspects of all trade practice investigations and coordinates all phases of NYBOT disciplinary proceedings.⁷

NYBOT's 21-person Compliance Department is headed by the Vice President, Compliance, who is assisted by an Assistant Vice President and a Manager of Special Investigations.⁸ The Department includes four Investigations Managers, four senior investigators, six investigators, one Head Compliance Assistant and one Compliance Assistant.⁹ The Department's investigators are organized into four teams. Each team is led by an Investigation Manager and includes a senior investigator and one or two investigators. Each team is assigned various NYBOT markets to monitor. However, all investigators are available to assist in oversight of any NYBOT market as needed, depending on the level of trading activity at the various NYBOT exchanges. In addition to these teams, the Manager, Special Investigations, and an investigator who works under him investigate unusual market events and potential rule violations of a serious nature in both Division A and Division B.

The Division found that the Compliance Department is staffed at adequate levels, and that NYBOT's recent reorganization of self-regulatory operations and hiring of senior compliance staff with substantial regulatory experience have improved significantly the Exchange's ability to conduct self-regulatory oversight.

⁷ The Compliance Attorney has been with NYBOT since September 2000. Prior to joining NYBOT's staff, the Compliance attorney had ten years of trial experience as an Assistant District Attorney in Manhattan and Brooklyn.

⁸ The Vice President, Compliance, has more than 20 years of regulatory experience, including both market and trade practice surveillance. Prior to his appointment to his current position in January 2001, he served for 16 years as NYBOT's Vice President, Market Surveillance. The Manager, Special Investigations, has nearly 30 years of regulatory experience, including several years as Trade Practice Manager at the New York Mercantile Exchange ("NYMEX"), and over 20 years on the staff of the Commission. The Assistant Vice President, Compliance, has 20 years of experience in futures regulation and compliance.

⁹ Two investigator slots remain unfilled. The Compliance Department believes that given the current level of NYBOT trading activity, it has sufficient staff to fulfill its responsibilities. Therefore, the Exchange is not actively recruiting for these positions.

B. Floor Surveillance

During the target period, NYBOT hired a former floor broker with ten years of trading experience to lead floor surveillance of all NYBOT markets.¹⁰ This investigator is on the floor throughout the trading session. The Exchange uses floor surveillance observations to detect trading violations, including noncompetitive trading; determine the physical location of floor members in relation to other floor members; determine a member's affiliations with other members; document various floor trading practices; identify trading patterns that are unusual for particular members; and deter members from engaging in illegal trading activity, including noncompetitive trading and trading before the open or after the close of the market. Additionally, floor surveillance provides the floor population an opportunity to interact with Compliance Department staff members on occasions when Exchange rules may need clarification.

Other Compliance Department investigators also conduct floor surveillance, routinely observing trading in each market on the open and close, at random times during the day, and when special conditions warrant. Once on the trading floor, a staff member typically remains to observe trading for approximately one hour, depending on market conditions. Investigators record their floor surveillance activity in a Floor Surveillance Log.¹¹ Division staff reviewed the Exchange's Floor Surveillance Log and found that during the target period investigators conducted daily floor surveillance of all futures and options markets. Six investigations were opened as a result of floor surveillance observations, such as cross trades not being bid or offered

¹⁰ This investigator also performs other duties, including reviewing exception reports and conducting investigations.

¹¹ A copy of the Exchange's Floor Surveillance Log can be found in Appendix 3. Log entries typically record the names of staff members conducting surveillance, the date, the time surveillance began and ended, and the market observed. When staff observe potentially violative activity, they initiate an investigation, and a memorandum concerning what they observed is included in the investigation file.

to the pit, trading after the close, and recordkeeping violations. Five of the six investigations were closed during the target period and resulted in the issuance of four staff warning letters.

C. Computer-Assisted Surveillance

The Exchange uses its automated surveillance system, the Compliance Analysis Review System (“CARS II”), as its primary means of detecting potential trade practice abuses. CARS II gives Compliance Department staff direct access to all Exchange data concerning trades, including the price change register, daily trade register, and data from the Trade Input Processing System (“TIPS”).¹² Trade data are downloaded to the CARS II trade server each day by the Exchange’s Market Information Services Department, and Compliance investigators have access to the data on the day following the trade date. Data are stored on-line for at least two years.¹³

On a daily basis, Compliance Department staff review CARS II exception reports. As discussed below, these reports were responsible for generating the majority of the Exchange’s investigations. The reports identify potential instances of trading ahead of customer orders; accommodation trading, including possible direct and indirect trading against customer orders; wash trading; and improper offsets or cross trades. Staff supplements the use of exception reports with several standardized computer reports, which are used during the course of investigations to develop cases, and initially to identify suspicious activity for further inquiry. These include reports regarding unmatched trades, mechanical adjustments (*i.e.*, changes made to trade details), and time and sales, as well as the CARS II Daily Broker Recap report, which lists all trading by each broker.

¹² TIPS automates the entire process of trade matching, validation, verification and correction. TIPS allows each broker’s clerk to enter the trade data that appear on his broker’s trading card directly into the matching process. This replaced manual transcription of trades onto buy/sell sheets. The system allows a broker’s clerk to review his broker’s trades as he has entered them, and provides immediate updates concerning the matched status of each trade.

¹³ As a result of the 1999 completion of the first phase of the NYBOT merger, investigators can access Division B data dating from January 1999.

In addition to reviewing these reports, investigators use CARS II to filter and sort trade data as desired and create customized reports that identify specific trading activity. For example, an investigator can design a report displaying all trading between two brokers or a group of brokers for a selected date. To narrow further the focus of the report, the investigator can then filter the data to view only those trades executed during a chosen time period, or sort the trades involved by desired parameters, such as price or time.

D. Timeliness and Adequacy of Investigations

1. Timeliness

The Division found that the Exchange had a significant problem with untimely investigations prior to the June 2000 formation of the Market Regulation Unit and the hiring of the Senior Vice President, Market Regulation. Specifically, at the start of the target period, there were 35 considerably untimely investigations still open, including eight that were open for more than one year, three that were open for more than two years, four that were open for more than three years, and 11 that were open for more than four years.¹⁴ Such timeliness problems can diminish deterrence and reduce overall self-regulatory effectiveness. When investigations remain open for extended periods, proof becomes problematic as memories fade and gaps in documentation become more difficult to fill.

However, since June 2000, the Exchange appears to have largely addressed the problem of untimely investigations. This was accomplished through a substantial effort to reduce the backlog of older investigations and improve investigation timeliness generally. The effort

¹⁴ The 11 investigations were the result of one Commission staff referral involving possible noncompetitive trading by 11 different floor brokers and firms. The Exchange chose to open separate investigation files for each broker or firm involved, rather than including the entire matter in a single investigation file. The primary reasons for the unduly, long delay in completing the 11 investigations (all of which were closed with a finding of no violations on July 5, 2001), were the large number of members and firms involved and the reassignment of the investigations on at least two occasions due to a protracted absence by the original investigator and the dismissal of a second investigator.

resulted in the closure of 19 of the 35 older investigations during the target period, and the closure of an additional 11 investigations by the end of June 2001, four months after the end of the target period. Therefore, only five of the 35 older investigations remain open, albeit for extended periods of time.¹⁵ The Exchange should move expeditiously to complete the remaining five investigations, and ensure that a backlog of investigations does not recur.

Investigations that were opened during the target period are also being handled in a more timely manner. Fifty-seven of the 87 investigations opened during the target period were closed within the one-year target period. Of the 30 investigations that remained open at the end of the target period, 22 had been closed and eight remained open by the end of June 2001. Only one of these eight newer investigations had been open for more than one year.

2. Adequacy

The Compliance Department initiates investigations whenever information obtained by staff indicates that a possible violation of Exchange rules may have occurred. That information may be derived from floor surveillance, review and analysis of computer-generated exception reports or other standardized or customized reports, or from external sources, including Commission and National Futures Association referrals and member or customer complaints. Of the 119 investigations handled by the Exchange during the target period, 65 were generated by routine Compliance Department trade practice reviews; 17 resulted from complaints, including seven member complaints, five anonymous complaints, and five customer complaints; 15 were based on Commission staff referrals, including, as noted earlier, 11 that were based on one referral; eight resulted from floor surveillance; eight were generated by routine clerk trading

¹⁵ As of June 2001, four of the five older investigations that remained open had been open for more than one year (Investigations 2000-014, 2000-016, 2000-017, and 2000-022), and one had been open for more than two years (Investigation 1999-077).

reviews; two were generated by random review of trading cards; three were based on referrals from another Exchange department or committee; and one was based on information developed in another matter.

All investigations are logged in the NYBOT Compliance Case Log.¹⁶ For each investigation, the Compliance Case Log reflects the source, the date the investigation was opened, the Exchange Division involved, the trade date and the market involved, the member(s) or firm(s) being investigated, the nature of the potential violation involved, the status of the investigation including the date it was closed or referred to a disciplinary committee, and the initials of the reviewing investigator.

Upon initiation of an investigation, an investigator requests information from the member(s) involved by sending an appropriate form letter. Once this information is received, the investigator reviews it in conjunction with other relevant records and trade data, to determine whether additional information or interviews with members are needed. If member or other witness interviews are conducted, the investigator prepares a memorandum concerning each interview. On-the-record interviews are recorded on audio tapes.

A “case management group” that includes the Vice President and the Assistant Vice President, Compliance; the Manager, Special Investigations; the Compliance Attorney; and the Manager of the relevant investigation team monitors the progress of investigations. Decisions on whether to close an investigation without further action or to refer the matter to a disciplinary committee for consideration of disciplinary action are made by the Senior Vice President, Market Regulation, based on recommendations from and consultation with the case management group. For each investigation closed without further action, an investigator prepares a “close-out”

¹⁶ A copy of the NYBOT Compliance Case Log can be found in Appendix 4.

memorandum describing the source of and reasons for the investigation, the facts developed during the course of the investigation, and the staff's conclusions and recommendations. For each case referred to a disciplinary committee, Compliance Department staff and the Compliance Counsel prepare an investigation report for presentation to the committee. These reports include the basis of the investigation, a summary of the complaint, a detailed summary of the facts, and the staff's conclusions and recommendations.

The Division reviewed the investigation files for all 119 investigations handled by the Exchange during the target period. The Division found that the Exchange's investigation files contained appropriate documentation, including copies of trading cards, order tickets, computerized exception reports, Daily Brokerage Recap reports, and time and sales reports reviewed during the course of the investigation. In instances where Compliance Department staff conducted interviews as part of an investigation, memoranda describing the interviews were included in the investigation files. Some files also contained tape recordings of the interviews. Investigations closed without further action contained a "close-out" memorandum in the file. The files for investigations referred to a disciplinary committee all contained detailed investigation reports.¹⁷ Most files included the appropriate sign-off of the team manager as well as other supervisory signatures.

The Division found some relatively minor documentation inadequacies in a few investigation files. For several investigations where trading cards or order tickets were requested, only one side of the document had been copied. Failure to copy both sides of such documents makes time-stamp review impossible, since many firms affix the exit timestamp to the back of order tickets and the Exchange affixes the trading card collection timestamp to the

¹⁷ See Section III, Disciplinary Program, at pp. 16-20, for a discussion of the two matters completed during the target period that were referred for disciplinary action.

back of cards. The Exchange, therefore, should take steps to ensure that copies of both sides of trading cards and order tickets reviewed during investigations are retained in investigation files. Further, in several investigations where on-the-record interviews were conducted, the file did not contain the tape recording of the interview. The Division notes in this connection that the Exchange has instituted new procedures for maintaining interview tapes in investigative files, effective June 2001.

The Division also found that the Exchange generally conducted thorough investigations during the target period. When the Division reviewed the investigation files for the investigations handled by the Exchange during the target period, it found that issues were developed thoroughly, appropriate analyses were performed, and that trading records for the entire day or days under review were requested. Some of the Exchange's investigations were complex in nature, and involved analysis of substantial amounts of data covering extended time periods. Where appropriate, investigations encompassed not only the parties to the trades in question, but also the traders' clerks, floor staff of the affected futures commission merchants ("FCMs"), and other traders in the pit. The Division found that the older investigations discussed above were appropriately closed.

The Division believes, however, that two important aspects of the Exchange's trade practice surveillance program need improvement. First, the Exchange should conduct routine trading card and order ticket recordkeeping reviews. The Exchange did not conduct such reviews on a regular basis during the target period, and looked for recordkeeping violations only during the course of ongoing investigations. Routine trading card and order tickets reviews are a crucial aspect of maintaining an adequate audit trail and provide support for effective and accurate trade reconstruction. Further, routine recordkeeping reviews should enable earlier

detection and more effective deterrence of trade timing and other recordkeeping violations. In addition, routine reviews will encompass the entire floor population, not just those members that are the subject of an investigation. The Division notes that the Exchange has recently taken steps to initiate a program of regular recordkeeping reviews, including the hiring of a former NYMEX employee whose responsibilities at the Exchange will include implementing and monitoring this program.¹⁸ This employee was responsible for implementing NYMEX's recordkeeping review program.

Second, the Division believes that the Exchange's trade practice surveillance program would be enhanced by instituting routine reviews of trades between house accounts of the same firm ("CTI 2 vs. CTI 2 trades") and between house and customer accounts at the same firm ("CTI 2 vs. CTI 4 trades"). This would allow the Exchange to monitor routinely for possible instances of wash or noncompetitive trading with respect to these types of trades.¹⁹ During the target period, the Exchange opened only one such investigation, Investigation 1999-080, which was the result of a Commission staff referral of nine CTI 2 vs. CTI 2 and CTI 2 vs. CTI 4 cross trades. The Compliance Department appropriately reconstructed each referred trade and determined the name and account number of the accounts involved. However, the Exchange did not pursue information from the clearing firm regarding possible common control or other relationships among the accounts, which may be indicative of wash trading. The Division believes that this made it impossible to verify whether the subject trades were permissible under

¹⁸ A copy of a recent NYBOT Trading Card Procedure Release, which reminded members of their trading card recordkeeping obligations under Exchange rules and the possible consequences of failure to comply, can be found in Appendix 5.

¹⁹ The Exchange's Compliance Handbook for Investigators ("Handbook") calls for investigation of the relationship, if any, between proprietary accounts involved in "house versus house" or CTI 2 versus CTI 2 trades. Item 24.00 of the Handbook, titled "House vs. House (2 vs. 2)" and item 25.00, titled "House vs. House (2 vs. 2)—non offset", at sections 24.20, paragraph (d) and 25.20, paragraph (d), respectively, provide as follows: "If necessary, conduct a further inquiry with the clearing member or the executing floor broker to determine the relationship between these proprietary accounts."

Exchange rules, and thus rendered the investigation less than adequate. Development and routine review of standardized reports concerning questionable CTI 2 vs. CTI 2 trades and CTI 2 vs. CTI 4 trades would improve the Exchange's ability to detect wash and noncompetitive trading in the context of such trades.

E. Conclusions and Recommendations

The Division found that the Exchange maintains an adequate trade practice surveillance program, that includes floor surveillance, electronic surveillance, and appropriate programs for the routine development of trade practice investigations. The Division also found that trade practice investigations were generally thorough, well analyzed, and adequately supported by documentation. However, the Division recommends that the Exchange enhance its trade practice surveillance program by instituting routine trading card and order ticket recordkeeping reviews and conducting routine reviews of CTI 2 vs. CTI 2 trades and CTI 2 vs. CTI 4 trades.

The Division also found that the Exchange appears to have largely resolved a significant problem with untimely investigations that existed at the outset of the target period through a substantial effort to reduce the backlog of older investigations and improve investigation timeliness generally. This effort has resulted in closure of all but five of the 35 investigations that were open at the beginning of the target period. In addition, investigations opened during the target period were closed in a timely manner. Nonetheless, the Exchange should move expeditiously to close the remaining five investigations that were open at the start of the target period and ensure that a substantial backlog does not recur.

Based on the foregoing, the Division recommends that the Exchange:

- **Conduct routine trading card and order ticket recordkeeping reviews.**
- **Conduct routine reviews of CTI 2 vs. CTI 2 trades and CTI 2 vs. CTI 4 trades.**

III. DISCIPLINARY PROGRAM

A. Disciplinary Committees and Procedures

Each individual Division B exchange generally operates under its own set of disciplinary rules and procedures (collectively referred to as “Division B rules”), which are virtually identical, and maintains its own Business Conduct Committee (“BCC”) and Floor Committee.²⁰ The individual BCCs are divided into two subcommittees. One subcommittee is responsible for determining whether a rule violation may have occurred. Members assigned to the other subcommittee are selected to serve on a hearing panel if a case is contested. The Division B Floor Committees are responsible for issuing summary fines.²¹ During the target period, each Division B Floor Committee was authorized to issue a fine not exceeding \$5,000 and/or a one-day suspension of trading privileges for violations of rules relating to floor trading practices such as the execution of cross trades, submission of TIPS data, and decorum.²²

²⁰ CITRUS and NYFE members generally are prosecuted under the rules of their respective exchange. Some NYCE rules, however, are applicable to all Division B exchanges. For example, the introduction to NYCE’s summary action rules states that for purposes of those rules, the term “Exchange” shall include CITRUS and NYFE. In addition, if the NYCE President were to determine that a CITRUS or NYFE matter should be prosecuted before a diverse BCC panel, the matter would be prosecuted under NYCE disciplinary proceeding rules.

²¹ The Floor Committees do not issue fines for audit trail recordkeeping violations. Presently, the Exchange is working to adopt a summary fine program for order ticket and trading card rule violations. This program would be administered by the Compliance Department. *See* note 22 for a description of the offenses subject to Floor Committee summary fines.

²² NYCE Rule 9.11, the NYCE rule that authorized Floor Committee members of any Division B exchange to impose summary fines, was amended and restated as NYCE Rule 9.08 shortly after the expiration of the target period. One significant change is that under NYCE Rule 9.08, a summary fine issued for certain trade practices may not be less than \$250. The enumerated offenses are: (1) offering into bids; (2) offering over existing bids; (3) bidding into offers; (4) bidding under existing bid; (5) improperly approaching the market; (6) otherwise causing a disruption of the marketplace; (7) causing an incorrect price to be disseminated by the Exchange; (8) bidding, offering, or executing a trade after a trading suspension has been declared; (9) bidding, offering, or executing a trade (i) in any delivery month during an opening or closing call after the caller has declared trading in such delivery month to have ended, or (ii) in any contract during an opening or closing call after the caller has declared trading to be closed; (10) failing to conform to the procedures set forth in rules concerning the proper execution of cross trades; (11) renegeing on a bid or offer after acceptance by another floor member; and (12) showing two hands and failing to trade ten contracts.

The Compliance Department is responsible for investigating possible rule violations and preparing investigation reports. If the Vice President, Compliance, concludes that a rule violation may have occurred, he may issue a warning letter or negotiate and enter into a settlement agreement, subject to BCC approval, at any time prior to a BCC meeting to determine whether a rule violation may have occurred.²³ If a case is referred to a BCC subcommittee for a determination of whether a rule violation may have occurred, a meeting will be scheduled and the subcommittee will be provided with the investigation report six to ten days before the meeting. The member who is the subject of the matter also is provided with a copy of the investigation report and is given the opportunity to respond in writing no later than five days prior to the scheduled meeting. Division B rules also allow members to address the BCC subcommittee. If the subcommittee concludes that a rule violation may have occurred, it may refer the case back to the Compliance Department with instructions for further action, enter into a settlement agreement with the respondent or, refer the matter for a hearing.

Division B rules authorize the Compliance Department and the BCC to negotiate and enter into settlement agreements that provide for a combination of the following sanctions: (1) a cease and desist order or a reprimand; (2) a fine not exceeding \$10,000 if entered into by the Compliance Department, or \$25,000 if entered into by the BCC, for each rule violation alleged plus the monetary value of any benefit received as a result of the alleged violation; (3) a suspension of up to three months for each rule violation alleged if entered into by the Compliance Department, or up to one year if entered into by the BCC; (4) expulsion; or (5) as part of a suspension or expulsion, an agreement that a member may not be employed by another member. As explained below, in any matter in which a determination is made that as a result of

²³ Nineteen of the 76 investigations closed during the target period resulted in the issuance of 23 Compliance warning letters. The warning letters were issued for, among other things, recordkeeping violations and failure to

a member's rule violation a customer incurred financial harm, the Compliance Department or the BCC may include restitution as a term of a settlement agreement.²⁴

If the BCC concludes that a rule violation may have occurred, and a settlement cannot be achieved, it will direct the Compliance Department to issue a "notice of charges." Upon receiving a notice of charges, a respondent must request a hearing within 20 days or the right to a hearing is deemed waived. In addition, if a respondent does not file an answer within 20 days, the failure to answer is considered an admission to all of the allegations set forth in the notice of charges. The Compliance Department may reply to a respondent's answer within five days of receiving an answer.

The Chairman of the appropriate Division B BCC is responsible for selecting a hearing panel from the BCC subcommittee that did not receive and review the investigation report for determining whether a rule violation may have occurred. The BCC Chairman also has discretion to determine the size of a hearing panel. Prior to the commencement of a hearing, a hearing panel may approve the entry into a settlement agreement with a respondent. If a case is not settled and a hearing is convened, the respondent has the right to be represented by legal counsel, to present witnesses and documentary evidence, and to cross-examine witnesses. The hearing panel's written decision must include a summary of the allegations contained in the notice of charges, a summary of the respondent's answer, a brief summary of the evidence, and a statement of findings and conclusions with respect to each charge.

In the event a hearing panel finds a respondent guilty of any charge, the written decision must include the specific rule that the respondent was found to have violated. If the violation

produce cross trade tickets.

²⁴ NYCE Rules 10.02(d) and 10.03(e), CITRUS Rules 102(d) and 103(e), NYFE Rules 522(d) and 523(e).

involved the execution of a customer transaction, the hearing panel must make a finding as to whether the customer incurred financial harm. The decision also must contain an order stating the imposed penalty. The imposed penalty may include any of the following: (1) a cease and desist order or a reprimand; (2) a fine not exceeding \$100,000 for each rule violation plus the monetary value of any benefit received as a result of the violation; (3) a suspension of up to one year for each rule violation; (4) expulsion; (5) as part of a suspension or expulsion, an agreement that the respondent may not be employed by another member; and (6) restitution to injured customers.

B. Adequacy of Sanctions Imposed

The Compliance Department referred two investigations that were completed during the target period to the NYCE BCC for consideration of charges.²⁵ Both resulted in the imposition of sanctions. Investigation 1999-163, which involved, among other things, non-competitive trading, resulted in a total of \$40,000 in fines and suspensions totaling 66 days against two members. The second investigation, Investigation 2000-122, resulted in a \$2,100 fine against one member for various trading card recordkeeping violations.

Although the monetary penalties and suspensions imposed appear to be reasonable in view of the violations alleged, the Division believes that the BCC should have included restitution to injured customers as part of the settlement in Investigation 1999-163. The investigation report for this case cites seven instances of trading on six trade dates between two NYCE members in which the Compliance Department found non-competitive trading.²⁶ The non-competitive trading included various combinations of indirectly taking the other side of a

²⁵ Disciplinary action in the two cases, Investigations 1999-163 and 2000-122, were finalized on March 8, 2001, just after the close of the target period.

²⁶ Investigation Report 1999-163 is attached as Appendix 6.

customer order (four instances for the first member and three instances for the second member), and withholding of customer orders (four instances for the first member and two instances for the second member). The second member was also charged with trading ahead of an executable customer order in one instance. Moreover, the investigation report identified 317 audit trail recordkeeping violations for the first member and 65 instances for the second member.

In five of the seven trade sequences analyzed, it appears to the Division that Compliance Department staff found definitive evidence of customer harm. Specifically, the investigation report decisively identified a specific dollar amount for two trade sequences (\$700, trade sequence one; \$1,325, trade sequence five), a range of loss for two trade sequences (\$500-1,000, trade sequence two; \$875-2,625; trade sequence four), and a minimum amount of loss for one trade sequence (customer lost “at least” \$1,075, trade sequence seven).²⁷

The minutes from the BCC meeting to determine whether a rule violation may have occurred indicate that the committee voted to offer settlement agreements to both members. The first member agreed to a settlement that included a \$25,000 fine, a 21-day suspension of trading privileges, a cease and desist order, and a “finding of customer harm, without determining the dollar amount, for his trading on October 5, 6, and 27 in 1999.” (emphasis added). The second member agreed to a \$15,000 fine, a 45-day suspension of trading privileges, and a cease and desist order. Although the investigation report identified two definitive trade sequences in which customers of the second member were financially harmed, his settlement agreement did not

²⁷ Potential customer harm also was found for trade sequence three, but staff was unable to offer a definite conclusion. In this connection, the analysis for trade sequence three states that one of the members may have benefited by \$750 and that his customers “could have been disadvantaged by an equal amount.” See Investigation Report 1999-163, page nine. The analysis for trade sequence six did not include any discussion of customer harm. Based on review of the relevant time and sales report, it appears that the customer in this sequence may have received a fair price despite the illegal trading activity between the two members.

include any finding regarding customer harm.²⁸ The minutes of the BCC meeting do not indicate why the BCC rejected Compliance Department staff's calculations regarding customer loss or why a finding of customer harm was included in the settlement agreement with the first member but not in the settlement agreement with the second member.

Division staff carefully reviewed the investigation report prepared by the Compliance Department and found that the calculations regarding customer harm were reasonable, and should have been included in the settlement agreements. In addition to the two definitive single amounts that were calculated, the BCC could have determined single dollar amounts for the three trade sequences that resulted in ranges of amounts. For example, for the two trade sequences that the report noted a range of financial harm, *e.g.*, the customer lost between 100 to 200 points (\$500-1,000), the BCC could have selected a point within the range as being reasonable and ordered restitution in these amounts. For the trade sequence in which the report concluded that the illegal trading activity between the two members cost the customer "at least 215 points (\$1,075)," restitution for at least that amount would have been appropriate.

When Division staff questioned Exchange staff regarding the lack of restitution in this case, Exchange staff explained that the BCC deliberated the issue but was unable to reach agreement regarding the amount of customer harm. Exchange staff also stated that pursuant to NYCE Rule 10.17(e), the relevant FCMs would be notified of the disciplinary action and the finding of financial harm to customers. The rule requires the FCMs to inform affected customers of the disciplinary action and the principal facts thereof.²⁹

²⁸ See Investigation Report 1999-163, pp. 12 and 19.

²⁹ By letters dated May 7, 2001, five FCMs were notified of the Exchange's settlement agreement with the first member. The letters stated that specified orders executed by the member "resulted in customer harm." Those letters are attached as Appendix 7.

The Division does not find this explanation persuasive. First, as noted above, the Division believes that the BCC could have reasonably calculated customer harm for five of the seven trade sequences identified in the investigation report. Second, because the BCC did not include a finding of customer harm in the settlement with the second member, NYCE Rule 10.17(e) was not applicable. Third, the Division does not believe that NYCE Rule 10.17(e) was intended to relieve the Exchange from ordering restitution in a case such as this where financial harm to customers can reasonably be calculated. In this connection, NYCE rules regarding the authority of the Compliance Department and the BCC to execute settlement agreements specifically require that “in any case in which it is concluded that the member may have violated an Exchange rule involving the execution of, or the failure to execute, a customer transaction,” the Vice President, Compliance, or the BCC “shall make a specific finding on whether the customer may have incurred any financial harm as a result of said violation and may negotiate and enter into a written settlement agreement whereby the member, with or without admitting guilt, agrees to make restitution to the customer . . .”³⁰

Restitution to customers should be an overriding objective of the Exchange when structuring settlement agreements with members. In those cases where customer loss can reasonably be determined, as it was in this case, the Exchange should order respondents to pay restitution to injured customers. If the BCC disagrees with the Compliance Department’s calculations regarding customer loss, or believes that customer loss cannot reasonably be calculated, the committee’s reasoning should be documented in the minutes of its meeting.

³⁰ NYCE Rules 10.02(d) and 10.03(e).

C. Conclusions and Recommendations

The Exchange issued monetary sanctions totaling \$42,100 and suspensions totaling 66 days in response to the two investigations completed by the Compliance Department during the target period that were forwarded to the BCC. These involved audit trail recordkeeping violations, non-competitive trading, taking the other side of customer orders, withholding customer orders, and trading ahead of executable customer orders. Although the sanctions issued by the Exchange appeared reasonable relative to the conduct being sanctioned, the Division believes that restitution should be included in settlements and decisions where customer harm can be determined to ensure that injured customers are appropriately compensated for losses due to a member's abusive trading activity. If the BCC finds that customer harm cannot reasonably be calculated, or if the committee disagrees with the Compliance Department's calculations of customer harm, minutes of the BCC meeting should document the committee's reasoning.

Based on its review, the Division recommends that the Exchange:

- **Order restitution in settlements and disciplinary decisions where the amount of customer harm can reasonably be determined. In the event that customer harm cannot reasonably be determined or if a disciplinary committee does not agree with staff's calculation of customer harm, the committee should articulate its rationale for such determination in its minutes.**