

Preliminary Review of NASD/LIFFE Contract Market Application
Submissions dated June 6, 2001, through June 25, 2001

I. DESIGNATION CRITERION

1. **Designation Criterion 2 - Capacity to Prevent Market Manipulation.** The Exchange has indicated that it anticipates signing an agreement with NASDR to perform its compliance and market surveillance functions. However the draft statement of work by NASDR is not sufficiently detailed for staff to evaluate the market surveillance program.

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2. **Designation Criterion 3 - Rules to Ensure Fair and Equitable Trading.**

The rules and trading procedures regarding pre-negotiated business still appear to allow some forms of pre-arranged trading, and to allow pre-arranged trades to be executed without exposure to an open and competitive market. The elements of the problem are as follows: Rule 4.8.1 bars pre-arranged trades "except where contemplated by the Rules (or by procedures implemented by the Exchange thereunder)," while under Trading Procedure 4.8.1, matching business may be procured for an order by pre-negotiation within the same member, with other members, or with customers.

Under one possible reading of the rules, pre-negotiation could involve disclosing customer orders not yet entered into the system. Trading Procedure 4.10.1(g) bars disclosing a customer order in whole or in part for the benefit of a member or any other individual or firm. However, Trading Procedure 4.11.7 appears to say that it is permissible to use knowledge of an order not yet fully submitted to the market to either (a) influence others to make trading decision or (b) deliberately provide information which allows others to make trading decisions, in order to procure matching business in the pre-negotiation context. The rules also provide for non-competitive execution of pre-arranged trades. Under Trading Procedures 4.8.2 and 4.8.3, orders for which matching business has been found by pre-negotiation may be entered to the Trading Host without delay between submission of the buy and sell orders involved, unless there is no resting bid or offer for the relevant contract month

or strategy, in which case a Request for Quote must be entered and the matching business can only be (and must be) entered after a five second delay for futures or a fifteen second delay for options.

The Division of Trading and Markets has previously allowed into effect a CBT policy regarding pre-execution communications concerning a/c/e trading which allows pre-negotiation of matching business, but requires, in cases where there was two-way pre-trade communication, a delay of five seconds for futures or fifteen seconds for options before the matching order could be entered, in order to give other market participants an opportunity to observe and participate in the trading activity. Therefore, unlike the proposed Nasdaq LIFFE rules, the CBT rule requires a delay between entry of the two sides of a pre-negotiated trade. Entry of both sides of a pre-negotiated trade without a delay to allow other market participants the chance to observe and participate would constitute noncompetitive trading. The Nasdaq LIFFE rules do require a five or fifteen second delay in cases where no resting buy or sell order in the relevant contract month or strategy exists. However, the delay follows an RFQ rather than a buy or sell order, and RFQs are not "live" orders exposed to the market risk of being hit or lifted by other market participants. On June 18, the Exchange indicated that the rules do at present allow entry of both sides of a prearranged trade without any delay between them (unless no resting order exists, as noted above), but stated that this part of the rules is still in flux and may be changed.

- a. Please explain how these rules comply with the designation criterion requiring rules to ensure fair and equitable trading.
- b. Please clarify whether customer permission is required prior to pre-negotiation in relation to the customer's order. Would pre-negotiation in connection with a customer order be considered exercise of discretion under Rule 4.20(a), and thus require written authorization?
- c. Please clarify the relationship between ATS Trading Procedure 4.20 with the pre-arranged trading rules mentioned above.
- d. For situations when the rule requires an RFQ, please clarify whether a response to the RFQ must be received before the pre-negotiated order can be entered.
- e. Do the rules require, when a pre-negotiated trade is entered, that a particular side --- customer or proprietary --- be entered first?
- f. Trading Procedure 4.15 ("Strategy Trades") calls for creation of separate markets for each strategy where one or more RFQs have been submitted. Are these markets completely separate from the primary market? If so, would the separate markets affect liquidity in the primary market, and if so, how? Would the separate markets be open to all, and offer all the same screen, including the same depth of screen?
- g. Trading Procedure 4.8 allows orders for matching business so obtained to be entered as cross-trades, without any delay between submission of the buy and sell orders, i.e., without real exposure to the competitive market. Under Trading Procedure 4.9, such cross-trades can be done in one of two ways. If no other bid or offer is in the queue for the contract month in question, a Request for Quote must be entered at least 5 seconds earlier for futures or 15 seconds earlier for options. If a bid and offer for the contract month are already in the queue, the pre-negotiated matching business may be entered as a cross-trade in the case of

certain contracts and/or certain categories of members if the trade is within the bid-offer spread. How does this apparent prearranged trading comply with this designation criterion?

- h. Although the application implies that system users will not see the status or origin of particular orders, it is not entirely clear what system users will see (see page 16 vs. page 33). Furthermore, it is not clear what is the depth of book that will be seen by system users. Will there be a user guide for the system (is there a user guide, or is a Liffe user guide available with commentary on the differences from the Liffe trading system to the Nasdaq/Liffe trading system)? If so, it would be helpful to see the user guide as well as to view the system.
- i.
- j. Draft Trading Procedure 4.2, addressing EFPs involving actuals, was eliminated. Does anything in the application now address such EFPs? Will they be permitted?
- k. Under Rule 4.21.2(b), it appears that Members who are not eligible contract participants could arrange block trades. This is contrary to previous Commission requirements that all block trade participants, whether agents or principals, be eligible contract participants.
- l. Please clarify the time relationship between Rule 4.21.8, which says the Exchange will publish block trades immediately after their receipt, and Rule 4.21.7(f), which says the Exchange will check the validity of block trade details and confirm the block trade's execution only when satisfied on validity. Which comes first, or are these steps simultaneous?
- m. Please provide an explanation of Rules 4.1.1, 4.4.1 and 4.8.1. Is an "allocation" what we call bunched orders?

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3. **Designation Criterion 4 - Trade Execution Facility.**

- a. Please provide the pro-rata algorithm, and please explain further how and why the exchange will decide which prioritization will be used in specific instances, or how surveillance would be able to know which prioritization was, in fact, used.
- b. Please clarify the meaning of the proviso attached to Trading Procedure 4.3.1(b), which is unclear. (The proviso says that for all orders, whether governed by price-time priority or price-pro-rata priority, if backwardation (bids higher than offers) exists at Market Open and is dealt with by the uncrossing algorithm specified in Trading Procedure 4.3.2, then Market On Open orders may take priority over Limit orders submitted during the pre-open period, by trading with other Market On Open orders, where such Limit orders cannot be executed during the opening algorithm.)

4. **Designation Criterion 5 - Financial Integrity of Transactions.** At this point the Designated Clearing Organization has been selected but no documentation or explanations of the clearing programs have been provided. These omissions affect a number of issues, which may take some time to review after the missing information is provided. At this point, it appears that the issues involved are substantive enough

that conditional designation would be difficult or inappropriate. Some specific questions based on what has been received include:

- a. The application states that members that engage in transactions with U.S. customers must comply with CFTC minimum financial standards, but all other members will be required to comply with the Exchange's minimum capital requirements (pg. 25), but these requirements are not spelled out. Please explain further.
 - b. What criteria must members satisfy in order to be "Public Order Members"? Are all Public Order Members regulated entities, either by the Commission or by a foreign regulatory entity? How will the Exchange issue an Exchange notice to members regarding specifying the criteria referred to in Section 3 before designation?
 - c. The Commission is familiar with SPAN, but not with TIMS. Can you provide any comparison between TIMS and SPAN?
 - d. Why would the CFTC issue such a no objection letter for a clearing member applicant for which we are the primary regulator as stated on page 21 of the application?
 - e. What is the required clearing fund deposit for Nasdaq LIFFE clearing members?
 - f. Under what conditions could the Exchange direct that a member that does not meet the criteria prescribe by the Exchange under Section 3.2.1, be allowed to execute, carry and/or clear transactions for another member under Section 3.2.2 of the Rules?
5. **Designation Criterion 6 - Disciplinary Procedures.** The rules specifically allow discipline, suspension, expulsion, and summary disciplinary action (see Section 5). This appears in order, except of course that the compliance contract is not yet in place.
6. **Designation Criterion 7 - Public Access to Rules, Regulations, and Contract Specifications.** No questions or comments at this time.
7. **Designation Criterion 8 - Ability to Obtain Information.** The application states that the Exchange would seek the assistance of the Commission in obtaining material data from other markets prior to such time as it is a signatory to intermarket information-sharing agreements. Would this intention be implemented pursuant to any procedures or rules?

II. COMMON PROVISIONS

1.

III. DESIGNATION CORE PRINCIPLES

2. Core Principle 2 – Compliance with Rules.

a. We cannot adequately evaluate the application with respect to this core principle until we have details of, and have seen a demonstration of, how NASDR would fulfill the Exchange's SRO compliance responsibilities.

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c. Please clarify the following situation: Rule 5.1.2(a) says no one can serve on a Disciplinary Panel or Appeal Panel if he is a named party or the employer, employee, fellow employee or affiliate of a party, if he has any significant ongoing business relationship with a party, or has a family relationship with a party. Rule 5.1.2(b) says that panel members must disclose any such conflicts to the President of the Exchange prior to considering any matter involving a party with whom a conflict exists, and Rule 5.1.2.A allows a party to request disqualification of a panel member on conflict grounds. These two parts of Rule 5.1 appear inconsistent—the first seems to be a mandatory bar to service on a panel if a conflict exists, while the second appears to allow such service if no party objects.

d. Would members' phone calls with customers will be taped? Rule 3.23.5 says the Exchange "may" require taping of phone conversations.

e. Is there an Exchange procedure to appeal a denial of membership?

f. Rule 2.2 defines Hearing Officer as an Exchange employee and an exchange employee may be the prosecutor, how would the exchange handle prevent any conflicts of interest in so that this would be a fair and adequate disciplinary program.

g. Please explain the reference to rule 4.4.13 found in Rule 5.3.A.1.

h. Does the right to counsel, afforded to the respondent under Rule 5.5.5, only exist at this stage of the proceeding?

i. Under Rule 5.7.4, can members of the Hearing Panel sit on the Appeals Panel? Likewise may any other employee or member who has had a role earlier in the disciplinary process be a member of the Appeals Panel.

- j. The time for appointment of an Appeal Panel of the Board and for their decision is not specified.
- k. Rule 5.7.3 limits the grounds for an appeal from the decision of a disciplinary panel to five bases. The Commission's rules have not limited the bases for appeal. Please explain this rule and how it is consistent with due process.

3. Core Principle 3 – Contracts Not Readily Subject to Manipulation.

- a. Requires a contract to fully analyze. Does the applicant follow the principles of Guideline No. 1? Price limit rules in Section 3.1 of ATS Trading Procedures seem to give the Exchange very broad discretion. Does the Exchange have a mechanism to determine the price limits? If so, what is this procedure or algorithm? Would the Exchange disclose its procedure for determining price limits to market participants? How do the price limit provisions conform to the Commission's policy that any price limits not be "overly restrictive" relative to cash price movements? If the applicant determines to trade a securities index contract, is it aware of the guidelines established by the President's Working Group on Financial Markets' pertaining to trading halts.

4. Core Principle 4 – Monitoring of Trading.

a. |

b.

c.

- d.
- e.
- f. Will Exchange provide guidelines/procedures for its officials in establishing any alternate settlement prices? In general, throughout the ATS trading procedures, exchanges employees exercise broad discretion in determining price limits, settlement prices, etc. Will there be guidelines, limits or restrictions, and will records be kept detailing how that discretion was exercised?
- g. It is stated that "generally" officers and employees of the Exchange will be prohibited from trading and "generally" will be prohibited from disclosing material on-public material obtained in the course of their employment. What is meant by "generally"?
- h. Trading Procedure 4.3.4 permits the Exchange to provide non-public information on counter-party details to the compliance departments of the Members who are party to the trades. Why does the compliance department of the counterparty need this information? How will the Exchange ensure that such information will be kept confidential?
- i.

5. **Core Principle 5 – Positions Limitations or Accountability.**

a.

- b. NOTE. Since NASDAQ I.IFFE does not currently have a commodity contract under consideration with its application Core Principle 5: Position Limits or Accountability is not required to be approved as a contract market at this time. However, depending on the commodity contract position limits or accountability rules may be required.

6. **Core Principle 6 - Emergency Authority.**

- a. Is the authority under Rule 4.15.1, to restrict or suspend trading be used other than in an emergency meant for physical emergencies only? (i.e. is the difference between Rule 4.15 vs. 4.16 that Rule 4.15 was meant to apply only to physical emergencies, while 4.16 was meant to apply to other emergencies? Furthermore,

Trading Procedure 3.5 allows two Exchange officials to suspend business in one or more contracts in case of an act of God or other event outside Exchange control, or an ATS technical failure, usually considered to be physical emergencies, yet Trading Procedure 3.5 references its implementation pursuant to Rule 4.16.

- b. Will the Exchange document the emergency-action decision-making process and the reasons for taking an emergency action?
7. **Core Principle 7 - Availability of General Information.** The Exchange has not indicated which commodity contracts it will trade, so it is not possible to evaluate.
 8. **Core Principle 8 - Daily Publication of Trading Information.** No questions or comments at this time.
 9. **Core Principle 9 - Execution of Transactions.** No questions or comments at this time.
 10. **Core Principle 10 - Trade Information.**
 - a. Please clarify what information the Trading System will require with respect to orders.
 - i. It is not clear what is required regarding the identify of the trader/user placing the order, the Responsible Person and the customer. Trading Procedure 4.4.2 requires that order tickets—which would include paper order tickets as required under Trading Procedure 4.4.1, or their electronic substitutes from electronic systems for order routing or order management, as permitted under Trading Procedure 4.5.1--must contain the following identifications: (1) member; (2) individual submitting the order to the ATS, and the ITM under which the order is submitted; (3) the individual completing the order ticket; (4) the customer identification (a code is sufficient) [it is unclear whether this is a customer account number or some other identifier]. However, the application (p. 17) states that each order entered into the system must contain the following identifications: (1) the ITM of the Responsible Person placing the order [but not also the identity of the individual submitting the order, as stated in Trading Procedure 4.4.2]; (2) the “account identifier” [it is unclear whether this is a customer account number or some other identifier].
 - ii. The draft also previously stated -- but the application does not -- that “orders which do not contain all [this] information will be rejected and sent back to the Member.” How incomplete can an entry be before it is rejected?
 - iii. If the Rules and Trading Procedures govern on this issue, rather than the statements in the application, this should be so clarified.
 - b. Reference in Rule 3.22.2 should be “CFTC” (a defined term) not “Commission.”
 - c. It is not clear from the application in what ways trade data will be able to be searched.
 - d. Please clarify what is meant by “aggregation” of orders under Trading Procedure 4.11.5. For example, does aggregating orders conflict with the requirement of

- Trading Procedure 4.4. that each order be recorded on a (paper or electronic) order ticket, which identifies the customer for that order
- e. The application notes time-stamping will be necessary if the market is closed when the order is received, or because a local network or system is temporarily unavailable, and that such orders must be entered into the system in the order received (p. 16). Please clarify whether these are the only permissible reasons for delay between order receipt and entry into the system (i.e., the only contexts in which paper order tickets will be used). In particular, please clarify whether it will be permissible to delay entering the order into the system in order to engage in pre-negotiation. Also, Trading Procedure 4.4.1 does not mention time-stamping an order ticket whenever the customer changes the order instructions. Is this a mistake or, if not, please explain.
 - f. Would execution time for both sides of a transaction be obtained? Would transactions be recorded in acceptable increments of time? This is no longer clear.

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g.

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11. Core Principle 11 - Financial Integrity of Contracts.

- a. Rule 3.20 says current requirements for financial resources will be disseminated as an Exchange Notice, but the rule does not spell them out. More information is necessary for analysis of compliance with this core principle.
- b. Should Rules 8.2.3. and 8.3.1(f) also allow consultation with DTFs?
- c. We cannot at present evaluate whether Exchange default procedures would integrate with those of the OCC.
- d. Would the Exchange have standards for acceptable custodians?
- e. No analysis can be carried out concerning whether the applicant has adequate procedures and staff to monitor compliance with its financial standards and the financial integrity of transactions executed on its system.
- f. It is not clear whether or not the Exchange itself will segregate customer funds from funds of intermediaries.

12. Core Principle 12 Protection of Market Participants.

- a. Questions regarding pre-arranged trading procedures are included under designation criterion 3, above.

- b.
- c. Please explain Rule 4.4, the cross-trading rule.
- d. Under what circumstances would the Exchange consent to a member executing a transaction for an Exchange employee or carrying an account therefore as allowed under Rule 2.8.1?
- e. Members may be located from abroad. In making a determination of whether an applicant is fit and proper under Rule 3.1.4, the Exchange may "have regard to the applicant's approval by a competent foreign regulatory authority." How will the Exchange draw the line?
- f. Will the rules require that those foreign members who solicit orders from U.S. person be registered with the CFTC? May a non-U.S. Clearing member of the Exchange transact business with U.S. customers (Rule 3.1.5)?
- g. Please provide an explanation of Rules 4.1.1 and 4.4.1. Also Rule 4.8.1.
- h. A more detailed description of the trade practice surveillance program is necessary for review. i.e. |
- i. Our questions regarding average price trades, under Rule 4.18.1, are included under Designation Criterion 3 (Fair and Equitable Trading).
- j. Under the bunched order rule, Rule 4.19(a), would the member be required to file its pre-determined allocation system with the Exchange? Would the member be required to keep this "record" for five years?
- k. The application notes time-stamping will be necessary if the market is closed when the order is received, or because a local network or system is temporarily unavailable, and that such orders must be entered into the system in the order received (p. 16). Are there any other permissible reasons for delay between order receipt and entry into the system (i.e., the only contexts in which paper order tickets will be used)?
- l. Trading Procedure 4.4.1 does not mention time-stamping an order ticket whenever the customer changes the order instructions. Is this a mistake or what is the explanation?
- m. Under Rule 3.7.2, an Exchange official can bust a trade that he believes was made at an unrepresentative price. Would any time limit be placed on the time period in which a request to break a trade could be made? To what extent must collateral consequences be taken into account before the decision to break a trade was made?

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(b)(5)**13. Core Principle 13 - Dispute Resolution.**

- a. It is not completely clear whether arbitration is voluntary. Rule 6.1.1 states that members and their customers shall arbitrate if the customer agreements so provides, or at the customer's option. This seems to suggest that member/customer agreements can contain mandatory arbitration clauses. Please elaborate. If the intention is to permit members to require their customers agreements to provide for arbitration, how is this consistent with CFTC policy as set out in the new regulatory framework, which does not allow mandatory arbitration of customer - member disputes. See proposed rule 166.5(b).

- b. As the agreement between Nasdaq LIFFE LLC and NASDR has not been received it is not yet possible to complete an evaluation of the application for compliance with this core principle.

14. Core Principle 14 – Governance Fitness Standards

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- b. What is a “family relationship” such as to disqualify a person from service on a disciplinary panel under Rule 5.1.2(a)(iv)?
- c. Would any natural persons directly or indirectly have more than a 10% interest?
- d.

e.

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f.

15. Core Principle 15 – Conflicts of Interest.

- a. Rule 5.1.2(a) and 5.1.2(b) appear inconsistent—the first seems to be a mandatory bar to service on a panel if a conflict exists, while the second appears to allow such service if no party objects. Please clarify.
- b. Rule 2.8.2 prohibits an employee from disclosing material non-public information where “information disclosed may assist another person in trading any Exchange contracts.” Such a rule would not appear to apply to commodity interests other than exchange contracts. Please explain.
- c. Please explain the need for Rule 2.8.4. Under what circumstances would an exemption be granted? Why is (b) limited to not having access in the course of his employment versus having actual access even if it were not obtained per se in the course of his employment?
- d.

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16. Core Principle 16 – Composition of Boards. Unless members gain an ownership interests, no consideration of this core principle is necessary.

17. Core Principle 17 – Recordkeeping.

- a. Will the Exchange keep Commission-required records separate from other records and keep back-up records at separate locations for the requisite time period? Where will the records be kept? Under what legal entity will they be kept?
- b. Will the Exchange provide to the Commission upon its request, at the Exchange's expense, either immediate hard copy records or machine-readable copies of any records on storage media in a format and coding structure specified by the Commission?
- c. Will the Exchange make available to the Commission or the Department of Justice immediately upon request: a means to review all records; an index of all records; the storage media; the audit system and its results; current information necessary to access records and indexes; and information from any technical consultant necessary to download information on the applicant's storage media to a medium acceptable under Regulation 1.31 (or, in the alternative, place in escrow and maintain a copy of the format of the media, the file format of all different information types maintained on the media, and the source code, documentation, and information necessary to access records and indexes maintained on the media)?
- d. The Exchange's rule should be amended to allow information to be disclosed, and books and records open for inspection, to the Department of Justice. See, e.g. Rules 2.4.1 and 3.2.5.
- e. What about access to records in the U.K.? The Exchange facilities will be located in London but "will be accessible by the CFTC and other appropriate authorities". Please explain "accessible"? Please explain other appropriate authorities, e.g., DOJ and SEC. Will the Exchange give CFTC unfettered access to all Exchange facilities?
- f. The above questions concern whether or how the Exchange's recordkeeping practices conform to Commission regulation 1.31.
- g. Will the Exchange make and keep records regarding the steps taken by the Exchange pursuant to Trading Procedure 3.2 to determine the settlement price, e.g., how a particular settlement price was calculated?
- h. Under Rule 3.7.2, an Exchange official can bust a trade that he believes was made at an unrepresentative price. Would the reasons be in writing and such record kept?
- i. No information has been provided regarding where Commission-required records and back-up records would be kept, or of maintenance of an original index and a duplicate of all records.
- j. Information on any electronic storage of records has not provided.

18. Core Principle 18 – Antitrust Considerations. No questions or comments at this time.