

August 21, 2001

Ms. Susan C. Ervin
Dechert Price & Rhoads
1775 Eye Street, N.W.
Washington, DC 20006

Mr. Arthur W. Hahn
Katten Muchin Zavis
525 West Monroe Street, Suite 1600
Chicago, IL 60661

Re: Application of Nasdaq LIFFE, LLC Futures Exchange for Designation as a Contract Market

Dear Ms. Ervin and Mr. Hahn:

By letters dated June 6, 2001 through, August 17, 2001, Nasdaq LIFFE, LLC Futures Exchange ("Nasdaq LIFFE" or "Exchange") has applied to the Commodity Futures Trading Commission ("Commission"), pursuant to Sections 5 and 6 of the Commodity Exchange Act ("Act"), 7 U.S.C. §§7 and 8, for designation as a contract market. The Commission has reviewed the materials submitted and has determined to designate Nasdaq LIFFE as a contract market, pursuant to Sections 5 and 6 of the Act, 7 U.S.C. §§7 and 8, subject to the terms and conditions of the accompanying order.

Concurrent with designation, the Commission approved, pursuant to Section 5c(c) of the Act, 7 U.S.C. §7a-2(c), Nasdaq LIFFE LLC Agreement Articles: I-IX; Nasdaq LIFFE Rules: 1.1-1.6, 2.1-2.11, 3.1-3.28, 4.1-4.21, 5.1-5.13, 6.1-6.4, 7.1, 8.1-8.5; Nasdaq LIFFE's ATS Trading Procedures: 1.1-1.3, 2.1, 3.1-3.7, 4.1-4.20; Trading Procedures for The Nasdaq LIFFE, LLC Security Futures Trading Facility (effective 08/21/01 to 12/21/01); and Nasdaq LIFFE Notices: General Notice: "Responsible Persons, General Notice Trading in Security Futures Products," and Exchange Notice: "Client Disclosure Requirements for ATS: Use of FIA's Standard Disclosure Statement."

The Commission's conditional designation is based upon, among other things, written submissions, explanations and representations provided by the Exchange describing the manner in which Nasdaq LIFFE will operate. The Commission's conditional designation is also based upon written submissions, explanations, demonstrations, and representations provided by Nasdaq LIFFE and The National Association of Security Dealers, Inc. ("NASD") concerning how NASD shall assist Nasdaq LIFFE in meeting the Exchange's self-regulatory obligations. The Commission's conditional designation is also based upon written submissions, explanations, demonstrations, and representations provided by Nasdaq LIFFE and The London International Financial Futures and Options Exchange ("LIFFE") concerning how LIFFE shall assist Nasdaq LIFFE in meeting the Exchange's self-regulatory obligations. Finally, the Commission's conditional designation is also based upon written submissions, explanations, and representations

provided by Nasdaq LIFFE and The Options Clearing Corporation (“OCC”) concerning how OCC shall assist Nasdaq LIFFE in meeting the Exchange's self-regulatory obligations.

In approving Nasdaq LIFFE’s application, the Commission is not approving the agreements covering services between Nasdaq LIFFE and NASD, between Nasdaq LIFFE and LIFFE, or between Nasdaq LIFFE and OCC. In this connection, Nasdaq LIFFE itself shall remain responsible for ensuring the performance of all self-regulatory functions required of it as a designated contract market under the Act and the Commission’s regulations, including enforcement of the terms of all Nasdaq LIFFE rules.

The Commission reminds the Exchange that the LLC Agreement, the ATS Trading Procedures, Exchange Notices, the exchange trading system, and both the identity of and self-regulatory services provided to the exchange by third-party providers are considered rules and, therefore, changes to such should be submitted pursuant to 5c(c) of the Act and Part 40 of the Commission’s regulations. The Commission also reminds the Exchange that the minimum contract size thresholds for block trades are considered rules, and should be submitted as such, pursuant to 5c(c) of the Act and Part 40 of the Commission’s regulations, for review of the applicability of the minimum block size thresholds to contracts on a case-by-case basis. In addition, the Commission reminds the Exchange that Position Limits or Position Accountability procedures must be specified for futures contracts listed by the Exchange. All Position Limits or Position Accountability procedures should be included with the Exchange’s filing to the Commission in connection with the listing of each futures contract submitted under the Commission’s certification or approval procedures. Moreover, the Commission reminds the Exchange that, due to its incorporation of NASD Code of Arbitration Procedures by reference, changes to those rules should be submitted by the Exchange pursuant to section 5c(c) of the Act and Part 40 of the Commission’s regulations.

Furthermore, the Commission reminds the Exchange that OCC is not a DCO and, therefore, OCC is limited to clearing security futures products at this time. The Commission finally reminds the Exchange that operation as an exclusively non-centralized market must terminate not later than December 21, 2001. The Commission recognizes that statutory or regulatory reasons may extend the period in which trading in security futures is only allowed on a principal-to-principal basis beyond December 21, 2001. In such a situation, the Commission expects the Exchange to submit an appropriate rule amendment to the Commission pursuant to section 5c(c) of the Act and Part 40 of the Commission’s regulations.

Sincerely,

Catherine D. Dixon
Assistant Secretary of the Commission

cc: Bob Fitzsimmons, Nasdaq LIFFE

UNITED STATES OF AMERICA

Before the

COMMODITY FUTURES TRADING COMMISSION

In the Matter of the Application of
Nasdaq LIFFE, LLC Futures Exchange
For Designation As a Contract Market

ORDER OF CONDITIONAL DESIGNATION

Nasdaq LIFFE, LLC Futures Exchange (“Nasdaq LIFFE” or “Exchange”), a Delaware limited liability company whose partners consist of The Nasdaq Stock Market, Inc. (“Nasdaq”) and LIFFE Ventures, Inc., a wholly-owned subsidiary of LIFFE (Holdings) plc (LIFFE (Holdings) plc, together with its subsidiaries being referred to herein as “LIFFE”), having submitted, pursuant to Section 5 and 6 of the Commodity Exchange Act (“Act”), 7 U.S.C. §§ 7 and 8, an application for designation as a contract market, and the Commodity Futures Trading Commission (“Commission”) having reviewed the application and the complete record in this matter, and for the reasons set forth in the Memorandum submitted to the Commission by the Divisions of Trading and Markets and Economic Analysis recommending that the Commission conditionally designate Nasdaq LIFFE as a contract market, the Commission finds that for purposes of this application the Exchange has demonstrated that it has or will comply with the requirements under the Act and the Commission’s regulations thereunder applicable to it. Therefore,

IT IS ORDERED, under Section 5 of the Act, 7 U.S.C. § 7, that the application of Nasdaq LIFFE for designation as a contract market is granted;

IT IS FURTHER ORDERED, that this grant of designation shall be subject to compliance with all sections of the Act and regulations thereunder applicable to Nasdaq LIFFE as a contract market and that this grant of designation and the commencement and/or continuance of exchange operations shall be specifically subject to the following conditions:

(a) Prior to the commencement of trading:

(1) Nasdaq LIFFE shall provide to the Commission an executed agreement between Nasdaq LIFFE and The National Association of Securities Dealers, Inc. (“NASD”), including all exhibits, for the provision of self-regulatory organization (“SRO”) services that shall be consistent, in all respects material to the self-regulatory responsibilities of the Exchange under the Act and the Commission’s regulations, with: the “Draft Compliance/Surveillance Procedures” dated June 25, 2001 (“Draft Compliance/Surveillance Procedures”); the “Executed Binding Term Sheet for Services between NASD, Inc. and the Nasdaq LIFFE Futures Exchange” dated July 20, 2001 (“binding term sheet”); and NASD’s July 17 demonstration to Commission Staff; with the exception that the NASD, at the direction of the Exchange, may choose to extend the period of time in which it uses manual as opposed to automated processes to meet its financial surveillance and employee trading surveillance obligations;

(2) Nasdaq LIFFE shall provide to the Commission an executed agreement between Nasdaq LIFFE and LIFFE, including all exhibits, that shall be consistent, in all respects material to the self-regulatory responsibilities of the Exchange under the Act and the Commission’s regulations, with: the executed “Letter of Intent between The Nasdaq Stock Market, Inc. and LIFFE (Holdings) plc” dated March 20, 2001 (“Letter of Intent”); pages 6-22 of

the Draft Compliance/Surveillance Procedures; LIFFE's demonstration of the trading system provided to CFTC staff on July 13, 2001; LIFFE's July 18 demonstration to Commission staff; and LIFFE's July 23 demonstration to Commission staff of the relevant real-time market services;

(3) Nasdaq LIFFE shall provide to the Commission an executed clearing and settlement services agreement between Nasdaq LIFFE and The Options Clearing Corporation ("OCC") that shall be consistent, in all respects material to the self-regulatory responsibilities of the Exchange under the Act and the Commission's regulations, with the Draft Security Futures Agreement for Clearance and Settlement Services dated July 30, 2001 ("Draft Clearing Agreement"); and

(4) Nasdaq LIFFE, through NASD, shall have implemented the futures-customized electronic surveillance and analysis systems and exception reports, or manual procedures, to be used in conducting the trade practice and market surveillance of principal-to-principal trading for Nasdaq LIFFE described in the "Day 1 (August 21, 2001) Surveillance Activity," and shall have demonstrated to Commission staff that those systems and procedures comply with applicable Criteria for Designation and Core Principles for Contract Markets under the Act and the Commission's regulations;

(b) Upon commencement of principal-to-principal trading:

(1) NASD shall provide SRO regulatory services as described: in the "Day 1 (August 21, 2001) Surveillance Activity" dated July 30, 2001; in the binding term sheet; in the Draft Compliance/Surveillance Procedures; and in NASD's July 17 demonstration to Commission staff and all such services will initially be provided through NASD's subsidiary NASD Regulation ("NASDR");

(2) LIFFE shall provide regulatory services and the trading system and support therefore as described: in the Letter of Intent; in the Draft Compliance/Surveillance Procedures; in LIFFE's July 13 demonstration to Commission staff of the trading system; in LIFFE's July 18 demonstration to Commission staff; and in LIFFE's July 23 demonstration to Commission staff of the relevant real-time market services; and

(3) OCC shall provide clearing and settlement services as described in the Draft Clearing Agreement;

(c) Prior to the commencement of trading that is no longer restricted to principal-to-principal transactions:

(1) Nasdaq LIFFE, through NASD, shall have completed the development and implementation of a financial surveillance program that complies with Commission regulations as interpreted by the Division of Trading and Market's Financial and Segregation Interpretations No. 4-1 and No. 4-2 and demonstrated to Commission staff that systems and procedures comply with applicable Criteria for Designation and Core Principles for Contract Markets under the Act and the Commission's regulations;

(2) Nasdaq LIFFE shall have provided to the Commission an agreement between Nasdaq LIFFE and NASD, including all exhibits, for the provision of arbitration services under NASD's Code of Arbitration Procedures that shall be consistent, in all respects material to the self-regulatory responsibilities of the Exchange under the Act and the Commission's regulations, with the Draft Compliance/Surveillance Procedures; and

(3) Nasdaq LIFFE, through NASD, shall have implemented the futures-customized operation of all NASD electronic surveillance and analysis systems to be used in conducting trade practice and market surveillance for Nasdaq LIFFE and shall have

demonstrated to Commission staff that those systems and procedures comply with applicable Criteria for Designation and Core Principles for Contract Markets under the Act and the Commission's regulations;

(d) Upon commencement of trading that is no longer restricted to principal-to-principal transactions:

(1) NASD shall provide SRO regulatory services as described: in the Draft Compliance/Surveillance Procedures; in the binding term sheet; and in NASD's July 17 demonstration to Commission staff; with the exception that the NASD, at the direction of the Exchange, may choose to extend the period of time in which it uses manual as opposed to automated processes to meet its financial surveillance and employee trading surveillance obligations;

(2) LIFFE shall provide SRO regulatory services and the trading system and support therefore as described: in the Letter of Intent; in the Draft Compliance/Surveillance Procedures; in LIFFE's July 13 demonstration to Commission staff of the trading system; in LIFFE's July 18 demonstration to Commission staff; and in LIFFE's July 23 demonstration to Commission staff of the relevant real-time market services; and

(3) OCC shall provide those clearing and settlement services described in the Draft Clearing Agreement;

(e) Principal-to-principal trading in security futures on Nasdaq LIFFE, which may commence on or after August 21, 2001, shall be pursuant to: "Nasdaq LIFFE LLC Agreement Articles I-IX; Nasdaq LIFFE Rules: 1.1-1.6, 2.1-2.11, 3.1-3.28, 4.1-4.21, 5.1-5.13, 6.1-6.4, 7.1, 8.1-8.8, as applicable; Trading Procedures for The Nasdaq LIFFE, LLC Security Futures Trading

Facility (effective 08/21/01 to 12/21/01)” and Nasdaq LIFFE will provide its members with the Nasdaq LIFFE Notice: “General Notice Trading in Security Futures Products;”

(f) Non-principal-to-principal trading in security futures on Nasdaq LIFFE, which may commence on or after December 21, 2001, shall be pursuant to Nasdaq LIFFE LLC Agreement Articles: I-IX; Nasdaq LIFFE Rules: 1.1-1.6, 2.1-2.11, 3.1-3.28, 4.1-4.21, 5.1-5.13, 6.1-6.4,7.1, 8.1-8.8; and Nasdaq LIFFE's ATS Trading Procedures: 1.1-1.3, 2.1, 3.1-3.7, 4.1-4.20 and Nasdaq LIFFE will provide its members with Nasdaq LIFFE General Notice: “Responsible Persons,” and Exchange Notice: “Client Disclosure Requirements for ATS: Use of FIA’s Standard Disclosure Statement;” and

(g) Operation as an exclusively non-centralized, principal-to-principal, market shall terminate not later than December 21, 2001.

Issued in Washington, D.C., this 21st day of August 2001.

By the Commission

Catherine D. Dixon
Assistant Secretary of the Commission

DCM Designation Form

August 20, 2001

To: The Commission

From: The Division of Trading and Markets
The Division of Economic Analysis

Subject: Application of Nasdaq LIFFE, LLC Futures Exchange (Nasdaq LIFFE or Exchange) for Designation as a Contract Market pursuant to Section 5 of the Commodity Exchange Act (Act).

Recommendation: Staff recommends that the Commission designate Nasdaq LIFFE as a contract market, and simultaneously approve Nasdaq LIFFE's proposed bylaws and rules.

Consulting: The Office of the General Counsel
The Division of Enforcement

Processing Information:

		Responsible Staff	
Official Receipt Date:	6/06/01	Riva Spear Adriance	418-5494
Review Period:	Review Period Extended		

I. Background of the Applicant.

By submissions dated June 6, June 25, June 29, July 2, July 13, July 17, July 18, July 24, July 26, July 30, August 7, August 10, August 13, August 14, August 15, and August 17, 2001, the Nasdaq LIFFE, LLC Futures Exchange, (Nasdaq LIFFE or Exchange), a Delaware limited liability company whose partners consist of The Nasdaq Stock Market, Inc. (Nasdaq) and LIFFE Ventures, Inc., a subsidiary of LIFFE (Holdings) plc, applied to the Commodity Futures Trading Commission (Commission) for designation as a contract market for the automated trading of futures contracts. The Exchange anticipates that it will offer trading of futures contracts on some or all of the following products: (i) Nasdaq-100 and Nasdaq composite stock indices, (ii) single securities, (iii) narrow-based securities indices, and (iv) other products as determined in the

future. However, the Exchange has stated that it will only offer trading on security futures when it first commences trading. When it is legally allowed, the Exchange may establish markets in options on these contracts. Access to the Exchange's trading system would either be through terminals located at a Member's office or via a computer-to-computer interface.

Nasdaq LIFFE will contract with The Options Clearing Corporation (OCC) to carry out clearing and settlement services for all security futures transactions under agreement with Nasdaq LIFFE. Nasdaq LIFFE intends to contract with the National Association of Security Dealers, Inc. ("NASD"), to perform several of the Exchange's self-regulatory duties, including conducting trade practice, financial and post-trade market surveillance, investigations, and dispute resolution services for the Exchange, subject to the decision-making authority of the Exchange. NASD will provide such services through its subsidiaries, currently through NASD Regulation ("NASDR") and NASD Dispute Resolution, Inc. Nasdaq LIFFE contracts would trade on the Nasdaq LIFFE CONNECT electronic trading system, which is an identical but separate copy of the LIFFE CONNECT trading platform developed and used by The London International Financial Futures and Options Exchange ("LIFFE"). Nasdaq LIFFE intends to contract with LIFFE to (1) operate the Nasdaq LIFFE trading system, (2) provide the trading platform, proprietary network, and facilities management and ongoing technical and other support and (3) carry out real-time market surveillance services for the Exchange. Nasdaq LIFFE also intends to establish arrangements to license software from LIFFE.

The Commission has not previously approved Nasdaq LIFFE as a contract market in any commodity futures or option contract. Accordingly, the Exchange has submitted to the Commission a proposed trade-matching algorithm, procedures and rules pertaining to Nasdaq LIFFE governance, disciplinary and arbitration procedures, trading standards, recordkeeping requirements, and various other materials to meet the requirements for a board of trade seeking

initial designation as a contract market. The Exchange also has submitted proposed rules that would establish OCC and NASD (currently through its subsidiaries NASDR and NASD Dispute Resolution) as the entities for clearing contracts and for compliance, surveillance and dispute resolution services, respectively, to carry out SRO responsibilities for contracts traded on Nasdaq LIFFE.

Nasdaq LIFFE, consistent with the limitations set forth in the Commodity Futures Modernization Act of 2000 (“CFMA”), has stated its intention to provide for trading between August 21, 2001, and December 21, 2001, solely on a principal-to-principal basis. During that period, Nasdaq LIFFE will not have, nor need to have, in place all the systems and procedures for surveillance of customer trading abuses or other customer protection issues that would be required for trading after December 21. In this context, Nasdaq LIFFE has provided the Commission staff with detailed materials and demonstrations as to how it intends to carry out its responsibilities as a designated contract market, and will complete all details before December 21, 2001. In addition, Nasdaq LIFFE has provided the Commission with clear and sufficient information describing the services that NASD and LIFFE and OCC have committed to provide to it, and written commitments from NASD and LIFFE of their intentions to do so.¹ However,

¹ NASD has stated that during the period of exclusively principal-to-principal trading it will provide to the Exchange the SRO regulatory services described in the “Day 1 (August 21, 2001) Surveillance Activity” dated July 30, 2001, as well as those in the binding term sheet dated July 20, 2001. It also stated that as of the commencement of non-principal-to-principal trading, it will provide SRO regulatory services to the Exchange that will be consistent in all material respects with the description of SRO regulatory services in the Draft Compliance/Surveillance Procedures dated June 25, 2001, and with the demonstration of those services provided to the CFTC staff, with the exception that the period of time in which it uses manual as opposed to automated processes to meet its financial surveillance and employee trading surveillance obligations may be extended.

LIFFE has stated that it is providing and, on the Exchange's launch date, will provide to the Exchange the relevant regulatory services described in Appendix B to the executed Letter of Intent between The Nasdaq Stock market, Inc. and LIFFE (Holdings) plc, dated March 20, 2001. As of the Exchange's launch date, LIFFE will provide to the Exchange the relevant Real Time Market Surveillance Services described in demonstrations to the Commission and in the Draft Compliance/Surveillance Procedures dated June 25, 2001. LIFFE has also stated that the trading system it will provide to the Exchange will be consistent with descriptions it has provided to the Commission. Both NASD and LIFFE represent that if a party decides to terminate the services, notice will be provided to the CFTC and each will undertake to continue to provide the services on a commercially reasonable basis and for a commercially reasonable time sufficient for the Exchange to obtain alternative services and systems.

the commercial terms of the Exchange's contracts with NASD and LIFFE have not been finalized. Nasdaq LIFFE must provide the relevant contracts to the Commission; therefore this matter is addressed by conditions to be imposed by the Commission as part of its designation of Nasdaq LIFFE.

As set forth in Section II and III of this memorandum, the Nasdaq LIFFE application demonstrates compliance with the Act's Section 5(b) Designation Criteria, Section 5(d) Core Principles, and Section 5c(b) Common Provisions regarding designation of contract markets. Accordingly, staff recommends that the Commission designate Nasdaq LIFFE as a contract market and simultaneously approve the following Nasdaq LIFFE LLC Agreement, Rules, ATS Trading Procedures and Notices: Nasdaq LIFFE LLC Agreement Articles: I-IX; Nasdaq LIFFE Rules: 1.1-1.6, 2.1-2.11, 3.1-3.28, 4.1-4.21, 5.1-5.13, 6.1-6.4, 7.1, 8.1-8.8; Nasdaq LIFFE's ATS Trading Procedures: 1.1-1.3, 2.1, 3.1-3.7, 4.1-4.20; Nasdaq LIFFE's Trading Procedures for The Nasdaq LIFFE, LLC Security Futures Trading Facility (effective 08/21/01 to 12/21/01); and Nasdaq LIFFE Notices: General Notice: Responsible Persons, General Notice Trading in Security Futures Products, and Exchange Notice: Client Disclosure Requirements for ATS: Use of FIA's Standard Disclosure Statement.

II. Analysis of the Nasdaq LIFFE LLC Agreement, Outsourcing Agreements with NASD, LIFFE and OCC, and Proposed Rules for Compliance with the Act’s Designation Criteria for Contract Markets

CONTRACT MARKET CRITERIA FOR DESIGNATION	Nasdaq LIFFE PROPOSAL	COMMENTS
<p>Sec. 5(a) Applications – “A board of trade applying to the Commission for designation as a contract market shall submit an application to the Commission that includes any relevant materials and records the Commission may require consistent with this Act.”</p>	<p>Combined Submissions dated June 6, through August 17, 2001</p>	<p>Acceptable See Attachments</p>
<p>Sec. 5(b) CRITERIA FOR DESIGNATION</p>		
<p>Designation Criterion 1 <i>In General</i> – “To be designated as a contract market, the board of trade shall demonstrate to the Commission that the board of trade meets the criteria specified in this subsection.”</p>	<p>Nasdaq LIFFE Rules, ATS Trading Procedures and LLC Agreement generally. Nasdaq LIFFE User Agreement. Nasdaq LIFFE API License Agreement. Description of the LIFFE Trading System. Draft Compliance/Surveillance Procedures dated June 25, 2001 (“Draft Compliance/Surveillance Procedures”). Nasdaq LIFFE/NASD Regulatory Services Agreement. Clearance and Settlement Agreement for OCC/Nasdaq LIFFE. Nasdaq LIFFE/LIFFE Agreement. Nasdaq LIFFE’s submissions dated June 25, June 29, July 2, July 13, July 24, July 30, and July 31.</p>	<p>Acceptable See Attachments</p>
<p>Designation Criterion 2 <i>Prevention of Market Manipulation</i> – “The board of trade shall have the capacity to prevent market manipulation through market surveillance, compliance, and enforcement practices and procedures, including methods for conducting real-time monitoring of trading and comprehensive and accurate trade reconstructions.”</p>	<p>Nasdaq LIFFE ATS Trading Procedure 4.10.1(a) (prohibits price manipulation or cornering of the market). Application (p.1.). Nasdaq LIFFE Draft Compliance/Surveillance Procedures (pp 6-33). See Attachment(s), (NASD/Nasdaq LIFFE Regulatory Service Agreement, LIFFE Letter of Intent, and Draft Compliance/Surveillance Procedures for the Nasdaq LIFFE, LLC Futures Exchange).</p>	<p>Acceptable. Nasdaq LIFFE is contracting with NASD to conduct its market surveillance, and NASD, currently through its subsidiary NASDR, has established procedures designed to reveal violations of various trading abuses, including attempts to manipulate futures prices. LIFFE’s market surveillance staff located at LIFFE’s London, England office, pursuant to an agreement between Nasdaq LIFFE and LIFFE, would monitor overall activity in each market on a real-time basis and coordinate surveillance activities with</p>

		<p>Rockville, Md. NASDR will provide Nasdaq LIFFE staff surveillance data regarding positions of large traders, deliverable supplies and futures and cash prices. Nasdaq LIFFE has represented that the market surveillance conducted for it by NASDR will be consistent in all material respects with the description of such surveillance set forth in the Draft Compliance/Surveillance Procedures, and with the demonstration of those services provided to Commission staff on July 17, 2001.</p> <p>NASD has represented that as of August 21, 2001, it will provide the regulatory services described in the Day 1 (August 21, 2001) Surveillance Activity dated July 30, 2001, and the Binding Term Sheet dated July 20, 2001; after the commencement of non-principal-to-principal trading it will provide the regulatory services described in its Regulatory Services Agreement. NASD represents that the above would be consistent in all material respects with the Draft Compliance/Surveillance Procedures.</p> <p>LIFFE has represented that it currently provides and, as of the Exchange's launch date, will provide the relevant regulatory services described in Appendix B to the executed Letter of Intent between The Nasdaq Stock Market, Inc. and LIFFE (Holdings) plc, dated March 20, 2001. As of the Exchange's launch date, LIFFE will provide to the Exchange the relevant Real Time Market Surveillance Services described in the Draft Compliance/Surveillance Procedures and in demonstrations to the Commission on July 23, 2001. LIFFE has also stated that the trading system it will provide to the Exchange will be consistent with descriptions it has provided to the Commission.</p>
<p>Designation Criterion 3 Fair and Equitable Trading – “The board of trade shall establish and enforce trading rules to ensure fair and equitable trading through the facilities of the contract market, and [sic] the capacity to detect, investigate, and discipline any</p>	<p><u>Nasdaq LIFFE</u>: Rule 4.10 and Trading Procedure 4.10 (prohibition of trading abuses); Rules 1.5, 2.2, and Section 5 (authority to detect, investigate and prosecute abuses); Rule 4.9, Trading Procedures 2.1 and 4.1, and Application pp. 2-4, 16-19 (access to</p>	<p>Acceptable. Nasdaq LIFFE is contracting with NASD to conduct its trade practice surveillance and investigate possible trading abuses, currently to be provided through NASD's subsidiary NASDR. See <i>infra</i> Discussion IV.D for recommended designation conditions.</p>

<p>– (A) transfer trades or office trades; (B) an exchange of futures – (i) futures in connection with a cash commodity transaction; (ii) futures for cash commodities; or (iii) futures for swaps; or (C) a futures commission merchant, acting as principle or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if the contract is reported, recorded or cleared in accordance with the rules of the contract market or a derivatives clearing organization”</p>	<p>secure and complete record of order and trade activity, fair and equitable trading); Rule 4.21 (Block Trades), Rules 4.4 and 4.5, Trading Procedures 4.7, 4.8, and 4.9 (Pre-negotiated Cross Transactions), Rule 4.17 (transfer trades); Rule 1.4 and draft Limited Liability Company Agreement (no limitation of liability or indemnification for violations of the Act or Commission Regulations by fraud or wanton and willful misconduct)</p>	<p>NASDR has established procedures for detection and investigation of trading abuses, and is in the process of customizing its advanced electronic surveillance and analysis systems for the futures context. Nasdaq LIFFE has represented that the trade practice and market surveillance conducted for it by NASDR will be consistent in all material respects with the description of such surveillance set forth in the Draft Compliance/Surveillance Procedures, and with the demonstration of those services provided to Commission staff on July 17 and July 23, 2001. See supra NASD and LIFFE representations under Designation Criterion 2.</p> <p>Information regarding all transacted prices and full market depth data on all resting bids and offers, updated on a real-time basis, will be available to market participants. Only members (and their employees) will have access to the trading system.</p> <p><i>See infra</i> Discussion IV (Block Trades; Pre-negotiated Business; August 21 to December 21 principal-to-principal Trading; Nasdaq LIFFE/NASD Regulatory Services Agreements).</p> <p>The Commission should remind the Exchange that minimum contract sizes for block trades are considered rules, and should be submitted as such to the Commission pursuant to 5c(c) of the Act.</p>
<p>Designation Criterion 4 Trade Execution Facility – “The board of trade shall (A) establish and enforce rules defining, or specifications detailing, the manner of operation of the trade execution facility maintained by the board of trade, including rules or specifications describing the operation of any electronic matching platform; and (B) demonstrate that the trade execution facility operates in accordance with the rules or specifications.”</p>	<p><u>Nasdaq LIFFE</u>: Rules Section 4 and Trading Procedures Section 4 (trade execution facility and order entry procedures); Application pp. 19-20 (trade execution facility).</p> <p><u>LIFFE</u>: Briefing Pack for the Financial Services Authority, Technical Presentation for Harvey Theberge, Nasdaq LIFFE Trading System Functionality, LIFFE Connect – How the Market Works, Technical Summary of Distribution Network, Network Performance and Scalability, Simulated</p>	<p>Acceptable</p> <p>Orders would be executed in accordance with either a strict price-time priority algorithm or a price-pro-rata priority algorithm. The first, called price-time, gives priority to orders at best prices, and then gives priority among orders at the same price based on time of entry into Nasdaq LIFFE. The second, called pro-rata, gives the same priority to all orders at the same price; orders at identical prices are filled in proportion to their size. The pro-rata algorithm assigns priority</p>

	<p>Security System, Computer Security Policy, Computer Security Standards, IT Security Implementation Guidelines</p>	<p>first order that betters a previous price gets price-time priority, and only after that order is filled, does the pro-rata algorithm allocate orders on a pro-rata basis. However the algorithm is set so that a limit is placed on the number of contracts to which priority is given, so that a very large priority order would not lock up the market. A minimum size is also set to prevent one trader from entering a very small order bettering the price of the previous priority order, in order to upset the priority of the previous order.</p> <p>These algorithms are similar to ones previously approved by the Commission for other electronic trading systems. Nasdaq LIFFE plans to apply the strict price-time priority algorithm to security futures products (which are all that will be offered when trading commences), and will publish an Exchange Notice stating the type of order prioritization to be used for each Exchange contract. Trading Procedure 4 describes the application of each algorithm.</p> <p>Nasdaq LIFFE has provided sufficient documentation and other information for Commission staff to conclude that the Nasdaq LIFFE trading system would comply with the IOSCO principles for screen-based trading systems.</p> <p>Functional demonstration and mock trading of all permitted order types conducted on July 18, 2001 for Commission staff from the Divisions of Trading and Markets, Economic Analysis, and Enforcement, Office of General Counsel, and Office of Information Resources Management, verified acceptable operation of the trading system. Functional demonstrations performed for Commission staff in London and New York on July 13th and 18th, 2001 verified that the system operates in accordance with the rules and specifications provided.</p>
<p>Designation Criterion 5 <i>Financial Integrity of Transactions</i> – “The board of trade shall establish and</p>	<p><u>Nasdaq LIFFE Rules</u> 3.1. (Membership), 3.2 (Capacity of members), 3.3 (Clearing arrangements),</p>	<p>Acceptable. Nasdaq LIFFE is contracting with OCC to provide clearing and settlement services. See infra</p>

<p>financial integrity of transactions entered into by or through the facilities of the contract market, including the clearance and settlement of the transactions with a derivatives clearing organization.”</p>	<p>Persons), 3.20 (Financial requirements for members), 3.21 (Financial requirements for clearing members), 3.23 (Accounting, records, and segregation requirements), 3.24 (Reports on financial condition), 3.26 (Submission of annual audited accounts), 3.27 (Margin Liability), 4.11 (Guarantee by clearing member), 4.12 (Clearing and registration of exchange contracts), Section 8 (Default Rules). <u>Draft Compliance/Surveillance Procedures</u>: Section II.C (Monitoring of “Early Warning Capital Requirements), and Section II. F (Coordination with OCC). <u>OCC</u>: Rules 203 (Maintenance of Accounts), 301 (Initial capital requirements), Rules 601 and 602 (Margins on positions); Chapter 11 (Suspension of clearing members), 613 (Escrow Deposit Program) and Chapter 13 (Determination of variation margin payments for Security Futures Products). <i>See also</i> OCC Rule 19b4 filing no. SR –OCC-2001-07 dated June 29, 2001.</p>	<p>conditions.</p> <p>OCC would be responsible for clearing and settlement services, and NASDR would carry out financial surveillance. The Commission should remind the Exchange that OCC is not a DCO and, therefore, is limited to clearing security futures products at this time.</p> <p>Members must designate one or more “Responsible Persons,” who would be responsible for all trading activity conducted under specific Individual Trading Mnemonic(s) (“ITM”) and for the supervision of all persons using their ITMs. Responsible Persons must be Members, employees of a Member or third parties authorized to exercise discretion on behalf of a Member; must agree to be bound by Exchange rules; and must be approved by the Exchange. Members are responsible for performance of all obligations arising from orders placed through their Responsible Persons. Every Member must be either an OCC clearing member or have a clearing arrangement with an OCC clearing member; thus, every Responsible Person would either be a financially qualified OCC clearing member, have a clearing arrangement with a financially qualified OCC clearing member, be an employee of a financially qualified OCC clearing member, be an employee of a Member that has a clearing arrangement with a financially qualified OCC clearing member, have authority to act on behalf of a financially qualified OCC clearing member, or have authority to act on behalf of a Member that has a clearing arrangement with a financially qualified OCC clearing member.</p> <p>In addition, certain members may be “Public Order Members.” Public Order Members must meet any criteria the exchange establishes for a member who executes, carries, and/or clears transactions for non-Member customers. Public Order Members that do not meet these criteria may only execute orders for</p>
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<p>Designation Criterion 6 <i>Disciplinary Procedures</i> – “The board of trade shall establish and enforce disciplinary procedures that authorize the board of trade to discipline, suspend, or expel members or market participants that violate the rules of the board of trade, or similar methods for performing the same functions, including delegation of the functions to third parties.”</p>	<p><u>Nasdaq LIFFE</u>: Rules Section 5 (disciplinary procedures and sanctions); Application pp. 24-25 (disciplinary procedures); <u>Nasdaq LIFFE/NASD draft Regulatory Services Agreement</u>; Draft Compliance/Surveillance Procedures.</p>	<p>Acceptable. Nasdaq LIFFE is contracting with NASD, currently such services would be provided by NASD’s subsidiary NASDR. See <i>infra</i> Discussion IV.D for recommended designation conditions.</p> <p>Disciplinary procedures would be consistent with Commission regulations and interpretive guidance regarding core principles.</p> <p>With authorization of Nasdaq LIFFE’s Market Supervision Department (“MSD”), NASDR would investigate possible rule violations and present written investigation reports to MSD, which will authorize and issue a notice of charges to commence a disciplinary proceeding. The disciplinary panel that will hear the charges will include a hearing officer employed by, and two exchange members selected by, Nasdaq LIFFE. NASDR would fill the prosecutorial function in these proceedings.</p>

<p>Designation Criterion 7 <i>Public Access</i> – “The board of trade shall provide the public with access to the rules, regulations, and contract specifications of the board of trade.”</p>	<p><u>Nasdaq LIFFE</u>: Application pp. 25-26 (public access).</p>	<p>Acceptable</p> <p>Nasdaq LIFFE represents that it will post all rules and contract specifications on its web site, and disseminate changes to rules and contract specifications by fax and email to all exchange members and all members of the public who are on a notification list.</p>
<p>Designation Criterion 8 <i>Ability to Obtain Information</i> – “The board of trade shall establish and enforce rules that will allow the board of trade to obtain any necessary information to perform any of the functions described in this subsection, including the capacity to carry out such international information-sharing agreements as the Commission may require.”</p>	<p><u>Nasdaq LIFFE</u>: Rule 3.22; Application pp. 26-27 (ability to obtain information).</p>	<p>Acceptable</p> <p>Members would be required to file reports and furnish timely information and testimony as prescribed or as requested by Nasdaq LIFFE.</p> <p>Nasdaq LIFFE represents that it will join the Intermarket Surveillance Group and become a party to other relevant information sharing agreements to assure that it has access to market surveillance data and other information relevant to its self-regulatory programs, or will seek the assistance of the Commission in obtaining material data from other markets when necessary.</p>

III. Analysis of Nasdaq LIFFE proposed rules with the Act’s Core Principles for Designation as a Contract Market.

CONTRACT MARKET CORE PRINCIPLES	Nasdaq LIFFE PROPOSAL	COMMENTS
<p>Sec. 5c(b) Common Provisions Applicable to Registered Entities (1) In General – “A contract market or derivatives transaction execution facility may comply with any applicable core principle through delegation of any relevant function to a registered futures association or another registered entity.” (2) Responsibility – “A contract market or derivatives transaction execution facility that delegates a function under paragraph (1) shall remain responsible for carrying out the function.”</p>	<p>Trade Practice surveillance and post-trade market surveillance will be contracted out to NASD, currently such services would be provided by NASDR. Real-time market surveillance will be contracted out to LIFFE. Dispute resolution services will be contracted out to NASD Dispute Resolution. Clearing services will be contracted out to OCC.</p>	<p>Acceptable</p> <p>Nasdaq LIFFE would remain responsible for compliance with designation criterion and core principles for which relevant functions will be contracted out.</p>
<p>SEC. 5c(c) NEW CONTRACTS, NEW RULES, AND RULE AMENDMENTS – (1) In General – Subject to paragraph (2), a registered entity may elect to list for trading or accept for clearing any new contract or other instrument, or may elect to approve and implement any new rule or rule amendment, by providing to the Commission (and the Secretary of the Treasury, in case of a contract for sale of a government security for future delivery (or an option on such a contract) or a rule or rule amendment specifically related to such a contract) a written certification that the new contract or instrument or clearing of the new contract or instrument, new rule, or rule amendment complies with this Act (including regulations under this Act). (2) Prior Approval – (A) In General – A registered entity may request that the Commission grant prior approval to any new contract or other instrument, new rule, or rule amendment.</p>	<p><u>Nasdaq LIFFE</u>: Rules Parts 1-8; ATS Trading Procedures Sections 1-4; LLC Agreement Articles I-IX. and Notices: General Notice: Responsible Persons, and Exchange Notice: Client Disclosure Requirements for ATS: Use of FIA’s Standard Disclosure Statement.</p>	<p>Acceptable</p> <p>The Commission should remind the Exchange that the LLC Agreement, the ATS Trading Procedures, Exchange Notices, the exchange trading system, and both the identity of and self-regulatory services provided to the exchange by third-party providers are considered rules, and changes should be submitted as such to the Commission pursuant to 5c(c) of the Act.</p> <p>Nasdaq LIFFE has requested that the Commission approve its proposed rules (including the proposed ATS Trading Procedures and Notices and LLC Agreement), in connection with its designation as a contract market. The Divisions of Economic Analysis and Trading and Markets recommend such approval pursuant to Section 5c(c)(2)(A) of the Act, since the LLC Agreement and rules do not violate any provision of the Act or the Commission’s regulations.</p>
<p>Contract Market Core Principle (C) –</p>	<p>Nasdaq LIFFE’s proposed rules do not violate</p>	<p>Acceptable</p>

<p>designation of a board of trade as a contract market, the board of trade shall comply with the core principles specified in this subsection. The board of trade shall have reasonable discretion in establishing the manner in which it complies with the core principles.”</p>	<p>July 2, July 13, July 24, July 30, and July 31; Rules, ATS Trading Procedures and LLC Agreement generally; User Agreement; API License Agreement. Draft Compliance/Surveillance Procedures. Draft Nasdaq LIFFE/NASD Regulatory Services Agreement. Clearance and Settlement Agreement for OCC/Nasdaq LIFFE. Nasdaq LIFFE/LIFFE Agreement. Description of the LIFFE Trading System.</p>	
<p>Core Principle 2 Compliance with Rules – “The board of trade shall monitor and enforce compliance with the rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.”</p>	<p><u>Nasdaq LIFFE</u>: Rule 2.2 and Trading Procedure 1.3 (compliance with rules and conduct); Rule 2.4 (supervision of the Exchange); Rule 4.10 and Trading Procedure 4.10 (prohibition of trading abuses); Rules 1.5, 2.2, and Section 5 (authority to detect, investigate and prosecute abuses); Rules Section 5 (disciplinary procedures and sanctions); Rule 4.9 and Trading Procedure 2.1 (access to trading system); Application pp. 27-28 (compliance with rules); Application p. 33 (electronic audit trail).</p>	<p>Acceptable. Nasdaq LIFFE is contracting with NASD to conduct its trade practice surveillance and investigate possible trading abuses, currently to be provided by NASDR. See infra Discussion IV.D for recommended designation conditions.</p> <p>NASDR has established procedures for detection and investigation of trading abuses, and is in the process of customizing its advanced electronic surveillance and analysis systems for the futures context. See additional discussion under Designation Criterion 3 above. Nasdaq LIFFE and NASDR have established appropriate procedures to promote the fairness of investigations and ensure appropriate, thorough, and timely investigative analysis. NASDR will have sufficient staff and electronic resources for conducting investigations, and has established procedures for regular report and document review to detect possible trading abuses.</p> <p><i>See generally</i> Discussion IV (Block Trades; Pre-negotiated Business; August 21 to December 21 Principal-to-Principal Trading; (Nasdaq LIFFE Regulatory Services Agreements).</p> <p>Nasdaq LIFFE will maintain a full electronic audit trail record of all trades and orders and other entries to the trading system, which will be available on-line for 30 days and stored off-line in a readily-accessible, machine-readable format for seven years.</p>

		clear and fair standards, and reasonable timelines for both summary and non-summary disciplinary actions.
Core Principle 3 <i>Contracts Not Readily Subject to Manipulation</i> – “The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation.”	Nasdaq LIFFE Application (pg. 1) (Nasdaq LIFFE ATS Trading Procedures 3.1) Draft Compliance/Surveillance Procedures (pp. 9-10).	Acceptable. Nasdaq LIFFE did not submit a futures or option contract with its contract market application. Nasdaq LIFFE intends to submit contract terms and conditions after it has been approved as a contract market. Nasdaq LIFFE submitted general price limit rules that will act as a price band above and below the current market price. The price band would have an inner and outer limit. Orders and trades that fall outside the inner limit will automatically alert real-time surveillance staff of increased market volatility and possible manipulation. “Orders entered at price levels falling outside the outer limits will be automatically prevented from trading by the ATS Central Processing System.”
Core Principle 4 <i>Monitoring of Trading</i> – “The board of trade shall monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.”	See Draft Compliance/Surveillance Procedures (pp. 6-33); See the Regulatory Services Agreement between National Association of Securities Dealers, Inc. and the Nasdaq LIFFE, LLC, Futures Exchange (provides for monitoring of large trader positions, deliverable supplies, and cash and futures prices).	Acceptable. Nasdaq LIFFE is contracting with NASD and LIFFE to conduct its market surveillance. See Discussion IV.D for recommended designation conditions. See supra Designation Criterion 2 for Nasdaq LIFFE, NASD and LIFFE representations. LIFFE will conduct real-time surveillance through trading and event alerts on the ATS Trading system, and NASDR (providing such services for its parent NASD) will conduct post-trade surveillance using daily data feed at the end of the trading day. The surveillance procedures outlined in the Nasdaq LIFFE application should minimize the potential for manipulation, distortion of prices, or disruption of delivery.
Core Principle 5 <i>Position Limitations or Accountability</i> – “To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall	See Nasdaq LIFFE application letter dated June 6, 2001 (pp. 29-30).	Position limits or Accountability limits will be established in the rules and contract specifications of Nasdaq LIFFE futures and options contracts. Those contracts are not included in the Nasdaq LIFFE

<p>for speculators, where necessary and appropriate.”</p>		<p>LIFFE application acknowledges CFTC Regulation 150 regarding the setting of position limits, exemptions from speculative position limits for bona fide hedging positions and inter-commodity spread positions, and aggregation of positions. The Commission should remind the Exchange that Position Limits or Position Accountability procedures must be specified for futures contracts listed by the Exchange. All Position Limits or Position Accountability procedures should be included with the Exchange’s filing to the Commission in connection with the listing of a futures contract submitted under the Commission’s certification or approval procedures.</p>
<p>Core Principle 6 <i>Emergency Authority</i> – “The board of trade shall adopt rules to provide for the exercise of emergency authority, in consultation or cooperation with the Commission, where necessary and appropriate, including the authority to – “(A) liquidate or transfer open positions in any contract; (B) suspend or curtail trading in any contract; and (C) require market participants in any contract to meet special margin requirements.”</p>	<p><u>Nasdaq LIFFE</u>; Rules 2.4.2, 4.15, and 4.16, and ATS Trading Procedure 3.5.</p>	<p>Acceptable</p> <p>By a majority vote, Nasdaq LIFFE’s Board could place into immediate effect temporary rules. Among other actions, the Board could order the liquidation of contracts or liquidation-only trading, suspend or limit trading, change delivery points and/or the means of delivery, and modify trading hours. Under Rule 2.4.2, no Board member could vote if such member knowingly had an interest in the matter. The member could participate in deliberations if, after the Board was informed of the conflict, disinterested Board members so decided upon consideration of the public interest. Nasdaq LIFFE could also take various actions in response to physical emergencies, which would include any circumstance that could have a severe or adverse effect upon Nasdaq LIFFE’s physical functions.</p>
<p>Core Principle 7 <i>Availability of General Information</i> – “The board of trade shall make available to market authorities, market participants, and the public information concerning – (A) the terms and conditions of the contracts of the contract market; and (B) the mechanisms for executing transactions on or through the facilities of the contract market.”</p>	<p>See Nasdaq LIFFE application letter dated June 6, 2001, pages 5, 20-24, 25, 26, 32-33.</p>	<p>Acceptable.</p> <p>Nasdaq LIFFE will publish its rules, regulations and contract specifications on its website.</p>

<p>Core Principle 8 <i>Daily Publication of Trading Information</i> – “The board of trade shall make public daily information on settlement prices, volume, open interest, and opening and closing ranges for actively traded contracts on the contract market.”</p>	<p>See Nasdaq LIFFE application letter dated June 6, 2001, page 32.</p>	<p>Acceptable.</p> <p>Daily information on settlement prices, volume and open interest would be made public through market data vendors.</p>
<p>Core Principle 9 <i>Execution of Transactions</i> – “The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions.”</p>	<p><u>LIFFE</u>: Briefing Pack for the Financial Services Authority, Technical Presentation for Harvey Theberge, Nasdaq LIFFE Trading System Functionality, LIFFE Connect – How the Market Works, Technical Summary of Distribution Network, Network Performance and Scalability, Simulated Performance of Trading Host, Technical Summary of Security System, Computer Security Policy, Computer Security Standards, IT Security Implementation Guidelines</p>	<p>Acceptable</p> <p>Orders would be executed in accordance with either of two algorithms. The first, called price-time, gives priority to orders at best prices, and then gives priority among orders at the same price based on time of entry into Nasdaq LIFFE. The second, called pro-rata, gives the same priority to all orders at the same price; orders at identical prices are filled in proportion to their size. <i>See supra</i> Designation Criterion 4, for additional discussion.</p> <p>Nasdaq LIFFE has provided sufficient documentation and other information for Commission staff to conclude that the Nasdaq LIFFE system would comply with the IOSCO principles for screen-based trading systems.</p> <p>Functional demonstrations performed for Commission staff in London and New York on July 13th and 18th, 2001 verified that the electronic facility provides for open, competitive, and efficient trading and otherwise complies with the IOSCO principles for screen-based trading.</p> <p>Nasdaq LIFFE provided ample evidence that it had adequately tested its system’s functions, capacity, and security and its interfaces to external systems, including its interfaces with OCC and NASDR.</p>
<p>Core Principle 10 <i>Trade Information</i> – “The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables</p>	<p><u>Nasdaq LIFFE</u>: Rules Section 4 (Trading Rules); Trading Procedures Section 4 (Trading on ATS); Application pp. 13-17, 33-34 (electronic audit trail, trade information).</p>	<p>Acceptable. Nasdaq LIFFE is contracting with NASD to conduct its surveillance and investigate possible trading abuses, currently to be provided through NASD’s subsidiary NASDR. <i>See infra</i> Discussion IV.D for recommended designation conditions.</p>

<p>purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market.”</p>		<p>NASDR has established procedures for detection and investigation of trading abuses, and is in the process of customizing its advanced electronic surveillance and analysis systems for the surveillance of futures transactions. <i>See</i> additional discussion under Designation Criterion 3 above.</p> <p>Orders submitted to the trading system must specify commodity, contract month, buy or sell, price, order type, volume, the Individual Trading Mnemonic of the Responsible Person under whose supervision the order is submitted, a CTI code, and an account identification that meets Exchange standards. The trading system will reject orders not containing required information. Bunched orders must carry a series designation.</p> <p>Nasdaq LIFFE rules make members responsible for all bids, offers, and contracts made under an ITM of a Responsible Person associated with the member; and also make Responsible Persons responsible for all trading activity conducted under their ITMs and for the supervision of all persons using their ITMs. The Exchange must be able to contact a Responsible Person when the Responsible Person’s ITM is in use. All orders not entered into the trading system immediately upon receipt by a member must be recorded on a paper order ticket time-stamped both on receipt of the order and on entry of the order into the trading system.</p> <p>The trading system will automatically capture all details of each trade in a comprehensive electronic audit trail, including the time of entry of each bid or offer and the time of execution to the nearest one-thousandth of a second. All activity and messaging within the trading system will be recorded in the trading system database in a secure and complete record that neither members nor system administrators will be able to edit. These data will be maintained on-line for 30 days, and stored off-line in</p>
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		<p>seven years. Nasdaq LIFFE security measures will include physical and electronic barriers to trading system hardware.</p> <p>NASDR's computer surveillance systems will enable NASDR to reconstruct Nasdaq LIFFE market transactions on both a real-time and T+1 basis and to sort all transaction history data as desired.</p>
<p>Core Principle 11 <i>Financial Integrity of Contracts</i> – “The board of trade shall establish and enforce rules providing for the financial integrity of any contracts traded on the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization), and rules to ensure the financial integrity of any futures commission merchants and introducing brokers and the protection of customer funds.</p>	<p><u>Nasdaq LIFFE Rules</u> 3.1. (Membership), 3.2 (Capacity of members), 3.3 (Clearing arrangements), 3.13 (Nomination and registration of responsible Persons), 3.20 (Financial requirements for members), 3.21 Financial requirements for clearing members), 3.23 (Accounting, records, and segregation requirements), 3.24 (Reports on financial condition), 3.26 (Submission of annual audited accounts), 3.27 (Margin Liability), 4.11 (Guarantee by clearing member), 4.12 (Clearing and registration of exchange contracts), Section 8 (Default Rules). <u>Draft Compliance/Surveillance Procedures</u> Section II.C (Monitoring of “Early Warning Capital Requirements), and Section II. F (Coordination with OCC). <u>OCC Rules</u> 203 (Maintenance of Accounts), 301 (Initial capital requirements), Rules 601 and 602 (Margins on positions); Chapter 11 (Suspension of clearing members), 613 (Escrow Deposit Program) and Chapter 13 (Determination of variation margin payments for Security Futures Products). <i>See also</i> OCC Rule 19b4 filing no. SR –OCC-2001-07 dated June 29, 2001.</p>	<p>Acceptable</p> <p>OCC would be responsible for all clearing and settlement functions for Nasdaq LIFFE.</p> <p>Nasdaq LIFFE is contracting with NASD to conduct its financial surveillance program and the parties anticipate reaching an agreement by August 31, 2001. Initially, such services would be provided to NASD by its subsidiary, NASDR. NASDR has an established financial surveillance program for brokers and dealers. The program includes on-site examination of the books and records of brokers and dealers, as well as an automated system for the review of periodic financial statement filings. NASDR's program is subject to SEC oversight.</p> <p>NASDR staff stated that it intends to modify its current broker-dealer financial surveillance program to accommodate FCMs trading on Nasdaq LIFFE. The modifications, however, are not fully developed at this time. For instance, NASDR has not completed drafting audit programs for the on-site examination of Nasdaq LIFFE member firms.</p> <p>Division of Trading & Markets Financial & Segregation Interpretations No. 4-1 and No. 4-2 set forth minimum elements that must be met for an SRO's financial surveillance program to satisfy the requirements of the Act and Commission regulations. NASDR staff have represented to the Division of Trading & Markets that the financial surveillance</p>

		<p>the minimum elements of the Division’s Interpretations, including the audit cycle set forth in Financial & Segregation Interpretation No. 4-2. NASDR also anticipates joining the Joint Audit Committee.</p> <p>Since the financial surveillance program is not fully developed and implemented at this time, the Division of Trading and Markets recommends that Nasdaq LIFFE’s designation as a contract market be conditioned upon a demonstration to the Commission that NASD has developed and implemented a financial surveillance program for Nasdaq LIFFE members that complies with Commission regulations as interpreted by Financial & Segregation Interpretations No. 4-1 and 4-2, prior to the commencement of non-principal-to-principal trading.</p>
<p>Core Principle 12 Protection of Market Participants – “The board of trade shall establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants.”</p>	<p><u>Nasdaq LIFFE</u>: Rule 2.2, Trading Procedure 1.3 (compliance with rules and conduct); Trading Procedures 4.4, 4.5, 4.6 (recording of customer orders); Trading Procedure 4.10 (prohibited practices); Trading Procedure 4.11 (order execution priority); Rule 4.13 (reporting executions to customers); Trading Procedure 4.12 (offering improvements to customers); Rule 2.8 (Exchange employee or officer transactions barred); Application p. 34 (protection of market participants); Nasdaq LIFFE Responses to CFTC Staff Preliminary Review,” dated July 13.</p>	<p>Acceptable. Nasdaq LIFFE is contracting with NASD to conduct its trade practice surveillance and investigate possible trading abuses, currently to be provided through NASD’s subsidiary, NASDR. See <i>infra</i> Discussion IV.D for recommended designation conditions.</p> <p>NASDR has established procedures for detection and investigation of trading abuses, and is in the process of customizing its advanced electronic surveillance and analysis systems for surveillance of futures transactions. See additional discussion under Designation Criterion 3 above. NASDR would use these systems to monitor for, among other things: trading ahead; impermissible cross-trades; prearranged and accommodation trading; wash trading; stop order, best execution, and execution timeliness violations; marking the close; error account, trade cancellation, and transfer trade violations; insider trading and fraud; EFP and block trade violations; position limit violations; and Exchange employee trading violations.</p>

		meet appropriate standards in receiving, recording, and handling customer orders, entering such orders into the trading system, and reporting order executions to customers. Except as may be permitted by rule, members are prohibited from executing wash trades, cross trades, accommodation trades, or prearranged trades. Members may not manipulate or attempt to manipulate the price of, or attempt to corner, any commodity. Transactions by Exchange officers and employees are generally prohibited; employees with only ministerial, secretarial or clerical duties and without access to material non-public information, a waiver may be possible.
Core Principle 13 Dispute Resolution – “The board of trade shall establish and enforce rules regarding [sic] and provide facilities for alternative dispute resolution as appropriate for market participants and any market intermediaries.”	Nasdaq LIFFE has provided us with NASD’s Code of Arbitration Procedure governing areas of arbitration and mediation. See also Section 6 of the Nasdaq LIFFE Exchange Rules regarding Arbitration.	Acceptable. Nasdaq LIFFE is contracting with NASD for arbitration services, to be provided by NASD’s subsidiary, NASD Dispute Resolution, Inc. See <i>infra</i> Discussion IV.D for recommended designation conditions. The proposed dispute resolution facility is voluntary. The Commission should remind the Exchange that, due to its incorporation of NASD Code of Arbitration Procedures by reference, changes to those rules should be submitted by the Exchange to the Commission pursuant to section 5c(c) of the Act.
Core Principle 14 Governance Fitness Standards – “The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, and any other persons with direct access to the facility (including any parties affiliated with any of the persons described in this paragraph).”	Nasdaq LIFFE LLC Agreement Article 5.7 (Eligibility for Service on Operating Board and Committees). Rule 3.1 (Membership Criteria). Rules 5.6 (Sanctions) and 5.9 (Summary Procedures).	Acceptable To become a Nasdaq LIFFE member, an applicant must be of good reputation and business integrity, have staff that are of good reputation with suitable qualifications and experience, implement and maintain internal procedures and controls in relation to the member’s intended business on the Exchange, and meet such other criteria as Nasdaq LIFFE may determine to be appropriate. Nasdaq LIFFE LLC Agreement Article 5.7 generally follows the standards set out in Commission regulation 1.63.

		Inc. will jointly own the Exchange. In its July 13 submission, the Exchange states that no natural persons will have more than a 10% interest, directly or indirectly.
<p>Core Principle 15 <i>Conflicts of Interest</i> – “The board of trade shall establish and enforce rules to minimize conflicts of interest in the decision-making process of the contract market and establish a process for resolving such conflicts of interest.”</p>	<p><u>Nasdaq LIFFE</u>: Rules 2.4.2, 2.8.2, 2.8.3, 2.8.4; 5.1.2, 5.1.2.A, 6.3.1.; Articles 5.5, 5.6, and 5.8 of the Nasdaq LIFFE LLC Agreement. <u>NASD</u>: Code of Arbitration Procedure Sections 10308, 10312.</p>	<p>Acceptable.</p> <p>The Nasdaq LIFFE LLC Agreement requires that members of a board disclose any conflict of interest concerning contracts and transactions; the agreement further provides procedures to be followed to ensure fair resolution of affected transactions. Under Rule 2.4.2, no Board member could vote if such member knowingly had an interest in the matter. The member could participate in deliberations if, after the Board was informed of the conflict, disinterested Board members so decided upon consideration of the public interest. The NASD Code of Arbitration Procedure requires that each arbitrator disclose such potential conflict of interest and provides the means for an arbitrator to be disqualified for a conflict of interest or bias.</p> <p>No Exchange employee, Board or committee member may inappropriately use or disclose material, non-public information obtained as a result of their fulfillment of their duties. No employee may trade any contract traded on the Exchange or cleared by OCC if the employee has access in the course of his/her employment to material, nonpublic information. Board or committee members with material, nonpublic information may continue to trade <u>only</u> in the ordinary course of their business, but not if it can be shown that such person would not have effected the transaction in the absence of such information.</p>
<p>Core Principle 16 <i>Composition of Boards of Mutually Owned Contract Markets</i> – “In the case of a mutually owned contract market, the board of trade</p>	<p><u>Nasdaq LIFFE</u>: Application p. 5 (membership).</p>	<p>Acceptable.</p> <p>Membership in Nasdaq LIFFE will not represent an ownership interest in the Exchange.</p>

<p>board reflects market participants.”</p>		<p>(Nasdaq LIFFE states that in the future it may establish a program under which some equity rights may be available.)</p>
<p>Core Principle 17 Recordkeeping – “The board of trade shall maintain records of all activities related to the business of the contract market in a form and manner acceptable to the Commission for a period of 5 years.”</p>	<p>Nasdaq LIFFE: Rule 3.22 (records); Application pp. 13-17, 33-34 (electronic audit trail and trade information); “Responses to CFTC Staff’s Preliminary Review,” dated July 13, items 17.a through 17.h (compliance with Commission Regulation 1.31).</p>	<p>Acceptable. Nasdaq LIFFE is contracting with NASDR to conduct its market and trade practice surveillance and investigate possible trading abuses. See infra Discussion IV.D for recommended designation conditions.</p> <p>Nasdaq LIFFE has represented that it will comply with Commission Regulation 1.31, and that a duplicate set of all Exchange trade data, which is kept in the United Kingdom, will also be kept by NASDR in Rockville.</p> <p>The trading system will automatically capture all details of each trade in a comprehensive electronic audit trail, including the time of entry of each bid or offer and the time of execution to the nearest one-thousandth of a second. All activity and messaging within the trading system will be recorded in the trading system database in a secure and complete record which neither members nor system administrators will be able to edit. These data will be maintained on-line for 30 days, and stored off-line in a readily-accessible, machine-readable format for seven years. Nasdaq LIFFE security measures will include physical and logical controls to protect trading system information.</p>
<p>Core Principle 18 Antitrust Considerations – “Unless necessary or appropriate to achieve the purposes of this Act, the board of trade shall endeavor to avoid – “(A) adopting any rules or taking any actions that result in any unreasonable restraints of trade; or (B) imposing any material anticompetitive burden on trading on the contract market.”</p>		<p>Acceptable</p> <p>Staff did not identify any antitrust issues in reviewing the application; however, staff did not specifically review the various service agreements for consistency with this core principle because, as noted above, these agreements are not being approved.</p>

IV. Novel or Unusual Issues

A. Block Trading: Minimum Threshold for Spread Transactions

The Exchange has provisions in place to facilitate block trading (Trading Procedure 4.21). The provisions generally conform to standards previously approved or allowed into effect by the Commission. For example, the maximum reporting time is 8 minutes (Rule 4.21.7(d)), which is shorter than the shortest maximum reporting time adopted by BrokerTec. A minimum block transaction size threshold has not been submitted; the Exchange will include the minimum block trade threshold with its certification or approval filing to trade a specific futures contract(s).

One feature of the Exchange's block trading rules which differs from those previously approved or allowed into effect by the Commission is a provision that allows specified block trade transactions, such as an inter-commodity spread or a volatility trade executed at a differential, to take place between commodities with different minimum block size thresholds (Trading Procedure 4.21.5). For such transactions, the lesser of the minimum block size thresholds would apply. For example, a block trade spread transaction involving one commodity having a minimum block trade threshold of 100 contracts and another commodity having a minimum threshold of 200 contracts could be executed as a block trade at the lower minimum threshold of 100 contracts.

Providing that the smaller of the two minimum thresholds establishes the minimum transaction size for inter-commodity block trade spread transactions executed at a differential is acceptable. In this regard, if the higher block trade threshold were applicable, spread transactions involving more than the minimum size for the smaller market may not take place if each leg were to be executed separately because the less liquid market might not be able to

absorb the larger transaction, or it is likely that the price would be affected materially making the transaction uneconomic. Since the minimum block threshold for a particular futures contract is directly related to the liquidity of that particular market, the less liquid contract can better absorb a transaction at the threshold established for that market and may not be able to absorb a transaction at the higher threshold that is based on activity of the more liquid market.

In addition, it should be noted that this provision is applicable only to spread transactions, which under Exchange rules are traded and priced separately from the regular market for that commodity. In this regard, the Commission has approved spread trading rules for many exchanges where the spread trade is priced and executed at a differential, without reference to the prices of the legs involved in such spread, in a separate market. The values of the legs of the spread are established later, usually after the close of trading, pursuant to exchange rules that typically only require that the legs be priced within the daily trading range of the commodity. In view of this, and since such differential trading takes place independently of trading in the regular “flat price” market, the setting of the prices of the legs does not contribute to price discovery in the commodity and such trading does not contribute to liquidity in the “flat price” marketplace. Thus, for these same reasons, inter-commodity block trade spreads executed under the subject Nasdaq LIFFE proposal also should have no impact on either the liquidity or the price discovery function of the applicable futures markets.

Based on the above, the proposal would not be inconsistent with Designation Criterion 2, requiring fair and equitable trading, and Core Principle 9, requiring a “competitive, open, and efficient market and mechanism for executing transactions.”

B. Pre-negotiated Business.

Exchange rules and trading procedures allow certain pre-negotiated business to be executed through the trading system as a cross trade, but otherwise prohibits pre-arranged trading (Rule 4.8). According to the Exchange (Responses to CFTC Staff's Preliminary Review, dated July 13, 2001), pre-negotiation allows a member to achieve a better price for a customer in situations involving insufficient market depth or insufficient "tight" bid/ask spread in the central order book, or in cases where the member believes a limit order may not execute speedily or may not necessarily be at the best achievable price.

Exchange rules permit an Exchange member to procure matching business for an order by pre-negotiation within the same member, with other members, or with customers (Trading Procedure 4.8.1). A member can delay submitting a customer's order to the system in order to pre-negotiate matching business (Trading Procedure 4.11.7), although the member must time-stamp an order ticket immediately upon the order's receipt and again on execution (Trading Procedure 4.4.1). Pre-negotiation must not prejudice the interest of a customer (Trading Procedure 4.7.2), and a member may not withhold a customer order in whole or in part for the benefit of a member or anyone else (Trading Procedure 4.10.1(g)). The member must provide written disclosure concerning pre-negotiated trading to customers that are Eligible Contract Participants, and must have obtained written consent for pre-negotiated trading from customers that are not Eligible Contract Participants. (Rule 4.5.1).

If a bid-ask spread is not presently resting in the system, pre-negotiated business may be entered only after the member enters a Request For Quote ("RFQ") for the relevant contract month or strategy, and then waits for five seconds (futures) or fifteen seconds (options on futures) (Trading Procedure 4.8.3). An RFQ is a system message requesting both bids and offers

in the contract in question. It carries no price and specifies no side. Although it can specify a desired volume, it will default to the minimum market obligation for the contract involved if it does not carry a volume indicator (Draft Compliance/Surveillance Procedures, p. 20). The member is required to submit pre-negotiated matching business to the trading system immediately following expiration of the required RFQ waiting period, regardless of how or whether the market has responded to the RFQ (Trading Procedure 4.8.3).

Pre-negotiated trades can be priced either inside or outside the existing bid-ask spread. Under the Exchange's price-time priority algorithm (Trading Procedure 4.3.1(b)), a pre-negotiated trade entered into the system will always take out resting orders at a better or the same price. Under the Exchange's price-pro-rata priority algorithm (Trading Procedure 4.3.1(a)), resting orders at the same price as the price of the pre-negotiated trade would share pro-rata with the same side of the pre-negotiated trade. As mentioned above, Nasdaq LIFFE plans to apply the price-time priority algorithm to security futures products (which are all that will be offered when trading commences).

Exchange trading procedures require that both sides of a pre-negotiated trade and any related RFQ, where applicable, be submitted to the trading system by the same member under the same Individual Trading Mnemonic (Trading Procedure 4.9.1). This would facilitate surveillance of such trades, and their differentiation from prohibited pre-arranged trading. Pre-negotiated trades would not otherwise be identified separately by the trading system.

Buy and sell orders involved in the pre-negotiated trade must be entered into the trading system separately. If the central order book for the contract month or strategy concerned is complete with both a bid and an offer, the buy and sell orders may be entered without any specified minimum delay between submission of the two sides (Trading Procedure 4.8.2).

According to the Exchange, because the separate buy and sell sides of a pre-negotiated trade must be entered separately, there will always be some interval between them — albeit one as small as human or computer capability can make it — and thus there is always a theoretical (if minimal) chance that another order could interrupt the cross of the two sides. Furthermore, as mentioned above, a pre-negotiated trade entered into the system will always take out resting orders at a better or the same price in cases of price-time priority, or will share pro-rata with the same side of same-price resting orders in cases of price-pro-rata priority algorithm.

In instances where the member submitting matching business is facilitating execution of customer business through a matching order on behalf of a member's account, the customer order must be entered first (Trading Procedure 4.9.1). When both sides of the matching business are customer orders, the orders must be submitted in accordance with Exchange rules governing order priority (Trading Procedures 4.9.1 and 4.11).

The Commission has not previously permitted entry of pre-negotiated business into an electronic trading system without a mandated delay of at least five seconds between submission of the buy and sell orders involved. The Division of Trading and Markets has previously allowed into effect a CBT policy regarding pre-execution communications concerning a/c/e trading. This policy 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. The purpose of this requirement was to give other market participants an opportunity to observe and participate in the trading activity.

The Division of Trading and Markets considers the rules regarding Nasdaq LIFFE's pre-negotiated trading to provide sufficient customer protections, such that customers would not be

prejudiced. As mentioned above, the Trading Procedures 4.7.2 requires that the customer not be prejudiced and Trading Procedure 4.4.1 requires the member to take appropriate steps to preserve an audit trail. The component orders of a pre-negotiated trade are still subject to the same strict trade-matching algorithm as any transaction. Accordingly, the component orders of a pre-negotiated trade entered into the system will always take out resting orders at a better or the same price in cases of price-time priority, or will share pro-rata with the same side of same-price resting orders in cases of price-pro-rata priority algorithm. The trading procedures allow a member to achieve a better price for a customer in situations involving insufficient market depth or insufficient “tight” bid/ask spreads in the central order book, or in cases where the member believes a limit order may not execute speedily or may not necessarily be at the best achievable price.

The Division of Economic Analysis is of the opinion that the Exchange’s pre-negotiated trading procedures are acceptable, since they should provide for fair and equitable trading with a competitive, open and efficient mechanism for executing these transactions (Designation Criterion 2, and Core Principle 9). When a pre-negotiated trade is entered into a liquid market, as mentioned above, both sides of the trade will always take out resting orders at a better or the same price or will match against each other and, accordingly, the resultant trade would be indistinguishable from non-pre-negotiated business from an economic and trade execution standpoint. When the market is illiquid and lacks a bid-ask spread, a RFQ must be entered before the pre-negotiated transaction may be entered into the system. This will allow all market participants an opportunity to participate in the transaction. Thus, the Division of Trading and Markets and the Division of Economic Analysis (collectively the “Divisions”) conclude that the

pre-negotiation procedures should not disadvantage customers or other market participants and should have no effect on the price discovery function of the market.

C. August 21 to December 21 principal-to-principal trading

When it first commences trading, Nasdaq LIFFE has stated that it would only offer trading on security futures. Under the Commodity Futures Modernization Act of 2000 (“CFMA”), the trading of security futures products is restricted to principal-to-principal trading between Eligible Contract Participants from August 21, 2001, until December 21, 2001 (“August-December 2001 principal-to-principal trading”). Therefore, during the period before December 21, 2001, the Exchange has stated that it would allow only Nasdaq LIFFE members that are both Eligible Contract Participants and OCC clearing members to execute and clear trades for their own account through the facility.

Nasdaq LIFFE has submitted trading procedures that would be in effect during the August-December principal-to-principal trading period. These trading procedures (“August-December 2001 principal-to-principal block trading procedures”) are similar to the Nasdaq LIFFE block trading rules, with the minimum size of the block set at one contract. The August-December 2001 principal-to-principal block trading procedures would allow members to negotiate transactions in listed stock futures during Exchange trading hours. Members would be notified of the August-December 2001 principal-to-principal block trading procedures through an Exchange General Notice, which explains the limitations on trading security futures products under the CFMA, the procedures that will govern such trading, as well as the period such procedures would be in effect.

Prohibited practices under the August-December 2001 principal-to-principal block trading procedures include price manipulation or cornering the market, wash transactions or

other such activities that create a misleading appearance of activity occurring in the market, compensation trades that are executed non-competitive trades in order to effect a monetary transfer between accounts, and accommodation transactions that attempt to conceal a trading abuse. NASDR would carry out surveillance for all such prohibited practices.

Members would be required to transact all trades at a price that represented a “Fair Market Value” for the trade. Once the trade negotiations had been completed, one counterparty would submit all the required trade information to Nasdaq LIFFE by fax, email or the Nasdaq LIFFE ATS trading system, for authorization as a block transaction. LIFFE personnel would review all such trades to verify trade details and the price. The trade would be rejected if the trade details were incomplete or incorrect, or if the price fell outside the “Fair Value Price Limits” set by the Exchange. The Fair Value Price would be based on the underlying stock price, implied volatility and forecast dividends. The Exchange would set dynamic price limits around the Fair Value Price, so that the limits move as the Fair Value Price moves. Once a trade had been authorized, the Exchange would notify the counterparties. All authorized trades would be reported to OCC at the end of each trading day. Nasdaq LIFFE would calculate daily settlement prices using a “Fair Value Algorithm,” which would take into account the official closing price of the underlying security concerned. These daily settlement prices would be distributed to OCC for its official settlement price calculation. Market participants would receive settlement prices through the ATS trading system and Quote Vendors on an ongoing basis.

Currently, all trading procedures that allow pre-negotiated transactions, whether EFPs, EFS, or block trading, have been approved or allowed by the Commission as adjuncts to a centralized market. The Nasdaq LIFFE August-December 2001 principal-to-principal block

trading procedures in effect would create a market that is exclusively a pre-negotiated block trading market. A contract market that is exclusively a pre-negotiated trading facility on a permanent basis would not comply with, among other things, Core Principle 9, which requires a board of trade to provide a competitive, open and efficient market. However, Nasdaq LIFFE is offering the non-centralized market for such products pursuant to statutory limitations on trading of security futures products under the CFMA. Therefore, the Divisions conclude that the Commission should allow Nasdaq LIFFE to implement the August-December 2001 principal-to-principal block trading procedures to create a non-centralized market, but only during the limited statutory period. After such period, trading would take place both on the Exchange's centralized market and through the use of its pre-negotiated trading procedures. **The Divisions recommend that the Commission remind the Exchange that operation as an exclusively non-centralized market is limited to the period under which trading in security futures is allowed only on a principal-to-principal basis pursuant to statutory restrictions.**

D. Regulatory Service Agreements

Nasdaq LIFFE is still in the process of contracting with third-party service providers to meet its regulatory obligations. Nasdaq LIFFE is still in the process of contracting: (1) with NASD to conduct its post-trade market surveillance, trade practice surveillance and compliance, financial surveillance and compliance and dispute resolution services; to be provided through its subsidiaries, currently through NASD Regulation ("NASDR") and NASD Dispute Resolution, Inc.; (2) with LIFFE to conduct its real-time market surveillance; and (3) with OCC to conduct its clearing and settlement services.

The Exchange has provided separate representations from NASD and LIFFE stating that each intends to provide regulatory services as set out in certain documents, which have been

provided to the Commission. In the case of NASD (for NASDR and NASD Dispute Resolution, Inc.), these documents include the Draft Compliance/Surveillance Procedures, a binding term sheet, a draft Regulatory Services Agreement, a representation of surveillance activity that would be ready on August 21, 2001, and presentations/demonstrations to Commission staff on NASDR systems and procedures to be utilized during the August 21, to December 21, 2001 principal-to-principal trading period and after. In the case of LIFFE, these documents include a Letter of Intent, the Draft Compliance/Surveillance Procedures, and presentations/demonstrations to Commission staff on LIFFE systems and procedures to be utilized during the August 21, to December 21, 2001 principal-to-principal trading period and after. In the case of OCC, the Exchange has provided a draft “Agreement for Clearance and Settlement,” and a copy of an OCC submission to the SEC on proposed rule changes and a representation that the final Agreement will not differ materially from the draft Agreement.

The Commission has not previously designated an exchange as a contract market when the contract market did not have final agreements that could be executed without material changes with third-party service providers of regulatory responsibilities.² The Divisions believe that Nasdaq LIFFE has made a sufficient showing under the circumstances described above (including the unique circumstance that at the time Nasdaq LIFFE begins trading, due to statutory restrictions on the trading of security futures, trading in its markets will be limited to trading by Eligible Contract Participants only), to warrant designation conditional upon the execution of the above-referenced agreements. **Therefore, since Nasdaq LIFFE has not signed final agreements with these third-party service providers, the Divisions believe that the**

² The Commission designated Futurecom as a contract market on March 13, 2000, with only final but unexecuted agreements with NFA and Bank of America. The designation order included the condition that such agreements be executed without material changes to the form attached to the designation order.

designation should be conditioned on: (1) receipt by the Commission, prior to commencement of trading, of (a) a final, executed version of the Regulatory Services Agreement between Nasdaq LIFFE and NASD, including all exhibits, which provides for (i) compliance/surveillance services that are consistent in all material respects with the Draft Compliance/Surveillance Procedures and the July 17 demonstration as set forth above, and for (ii) arbitration services under NASD's Code of Arbitration procedures; (b) a final, executed version of an agreement between Nasdaq LIFFE and LIFFE for the provision of regulatory services and a trading system that are consistent in all material respects with pages 6-22 of the Draft Compliance/ Surveillance Procedures Manual, the July 13 demonstration, the July 18 demonstration and the July 23 demonstration as set forth above; and (c) a clearing and settlement services agreement between Nasdaq LIFFE and OCC consistent in all material respects with the Draft Security Futures Agreement for Clearance and Settlement Services dated July 30, 2001 ("Draft Clearing Agreement"); (2) demonstration to the Commission staff, prior to trading, that the implementation of the futures-customized operation of all NASD electronic surveillance and analysis systems or manual procedures to be used in conducting the trade practice and market surveillance of principal-to-principal trading for Nasdaq LIFFE described in the "Day 1 (August 21, 2001) Surveillance Activity" and complete futures-customized exception reports therefrom complies with appropriate designation criteria and core principles of the Act and the Commission's regulations; (3) demonstration to Commission staff, prior to commencement of non-principal-to-principal trading, that the implementation of the futures-customized operation of all NASDR electronic surveillance and analysis systems to be used in conducting trade practice and market surveillance for Nasdaq LIFFE, and complete, futures-customized exception reports therefrom complies with appropriate designation criteria and core principles of the Act

and the Commission's regulations,; and (4) demonstration to Commission staff, prior to commencement of non-principal-to-principal trading, that the completion of the development and implementation of a financial surveillance program that complies with Commission regulations as interpreted by the Division of Trading and Market's Financial and Segregation Interpretations No. 4-1 and 4-2 complies with appropriate designation criteria and core principles of the Act and the Commission's regulations.

V. Attachments

- A. June 6, 2001 Application Letter from Nasdaq LIFFE to the Commission
- B. Nasdaq LIFFE Application
- C. Nasdaq LIFFE Rules
- D. Nasdaq LIFFE ATS Trading Procedures
- E. Nasdaq LIFFE Exchange Notices
- F. Nasdaq LIFFE LLC Agreement
- G. Day 1 (August 21, 2001) Surveillance Activity
- H. Trading Procedures for The Nasdaq LIFFE, LLC Security Futures Trading Facility (effective 08/21/01 to 12/21/01) and General Notice: Trading in Security Futures Products
- I. Nasdaq LIFFE Responses to Staff Questions, dated June 29, July 2, July 13, July 17, July 18, July 24, July 30, August 7 and August 10, 2001
- J. Draft Compliance/Surveillance Procedures dated June 25, 2001
- K. Draft NASDR Market Regulation Department Insider Trading Section Procedures Manual
- L. Draft User Agreement
- M. Draft API License Agreement
- N. Status of Nasdaq LIFFE Agreements dated July 30, 2001
- O. LIFFE's Presentations on July 13, 2001 on the LIFFE Trading System
- P. NASDR's "Nasdaq LIFFE Regulatory Services Program," demonstration materials dated July 17, 2001
- Q. Nasdaq LIFFE Trading System Functionality demonstration materials dated July 18, 2001
- R. LIFFE CONNECT User Manual
- S. LIFFE Presentation dated July 23, 2001 on LIFFE's regulatory service programs
- T. Draft NASDR Assessment Letter
- U. Nasdaq LIFFE Market Member Application Form
- V. NASD, Inc. and Nasdaq LIFFE Executed Binding Term Sheet for Services dated July 20, 2001
- W. Letter of Intent between Nasdaq Stock Market and LIFFE (Holdings) plc dated March 20, 2001

- X. Draft Regulatory Services Agreement between NASD, Inc. and the Nasdaq LIFFE, LLC Futures Exchange
- Y. Amendment to OCC's pending rule filing to the Security & Exchange Commission, dated August 10, 2001; with the final version of the Security Futures Agreement for Clearing and Settlement Services, between OCC and Nasdaq LIFFE attached as Exhibit B.
- Z. Representation Letters from NASD and LIFFE regarding their provision of regulatory services for Nasdaq LIFFE, dated August 10, 2001, and August 15, 2001, respectively.