

**RULE ENFORCEMENT REVIEW
OF NYSE Liffe U.S.**



Division of Market Oversight

April 20, 2012

Rule Enforcement Review of NYSE Liffe U.S.

I. Introduction

The Division of Market Oversight (“Division”) has completed a rule enforcement review of the trade practice surveillance program of NYSE Liffe U.S.¹ (“NYSE Liffe” or “Exchange”). The review focused on compliance with two core principles under Section 5(d) of the Commodity Exchange Act (“Act” or “CEA”), as amended by the Commodity Futures Modernization Act of 2000, and Part 38 of the Commission’s regulations. The Division’s review focused on Core Principles 2 (*Compliance With Rules*) and 12 (*Protection of Market Participants*), which relate to an exchange’s program for enforcing its rules, conducting disciplinary proceedings, and protecting market participants from abusive practices.² The review covered the period from November 1, 2009 through November 1, 2010 (“target period”).

II. Methodology

As explained below, the National Futures Association (“NFA”) provides a number of regulatory services for NYSE Liffe. Accordingly, to assess the Exchange’s compliance with the above core principles, Division staff reviewed numerous documents created by both NYSE Liffe’s Compliance Department (“Compliance Department”) and NFA staff in the performance of the Exchange’s trade practice related self-regulatory functions. These documents included, among others, computer reports generated by NFA’s automated surveillance systems and other

¹ NYSE Liffe U.S. is the brand name of NYSE Liffe, LLC, the legal entity registered with the Commission as a designated contract market (“DCM”). In February of 2009, NYSE Euronext began to market its U.S. derivatives business under the name NYSE Liffe U.S. while the name NYSE Liffe was used to refer to its entire global derivatives business. NYSE Liffe, LLC, continues to be the legal entity designated as a DCM. See <http://www.nyse.com/pdfs/03-2009.pdf>.

² The Division’s review of NYSE Liffe was commenced prior to the effective date of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010) (“Dodd-Frank”). Accordingly, the core principles cited above refer to Core Principles 2 and 12 prior to their amendment by Dodd-Frank.

reports used routinely for trade practice surveillance; trade practice investigation and inquiry files; meeting minutes from the Exchange's Regulatory Oversight Committee ("ROC"); annual reports of the ROC;³ investigation, inquiry, and disciplinary logs; and provisions of the Regulatory Services Agreement between NYSE Liffe and NFA ("RSA") which describe the scope of the self-regulatory services performed by NFA.

In addition, Division staff interviewed senior Compliance Department and NFA officials, including NYSE Liffe's Chief Regulatory Officer ("CRO") and NFA's Senior Manager and Associate Director for its Trade Practice and Market Surveillance ("TPMS") group. The Division also conducted a site visit of NFA's TPMS group on May 19, 2011. During this site visit, Division analysts observed NFA's automated surveillance systems and reviewed how NFA staff assigned to the Exchange disposed of exception reports previously generated by NFA's automated surveillance system.

The Division provided NYSE Liffe with an opportunity to review and comment on a draft of this report on February 10, 2012. On February 24, 2012, Division staff conducted an exit conference with Exchange officials to discuss the report's findings and recommendations.

³ The Division reviewed ROC annual reports from 2009 and 2010.

III. Summary of Findings and Recommendations

A. Findings

- NFA uses automated exception reports and tools to effectively identify potential trading violations and to conduct initial inquiries.
- The Exchange maintains a small but highly experienced staff in its Compliance Department. In particular, the CRO has considerable experience with compliance functions, the CEA, and Commission regulations. The Division also found, however, that the CRO performs a number of additional duties that have the potential to distract him from his compliance responsibilities.
- NFA staff members are well trained and capable. The analyst with primary responsibility for conducting trade practice surveillance for NYSE Liffe's markets is highly qualified and has considerable experience. The number of NFA staff members assigned to Exchange matters was sufficient to properly conduct trade practice surveillance and trade practice investigations for NYSE Liffe given the Exchange's trading volume during the target period. However, there has been a recent dramatic increase in trading volume on NYSE Liffe.
- Inquiries, which are used to investigate unusual trading activity, are typically initiated by NFA. NFA may open and close inquiries without prior Exchange approval. When an inquiry is closed with no further action, NFA creates an inquiry report summarizing the facts of the inquiry. If an inquiry reveals a potential violation of Exchange rules, then the inquiry is designated an investigation and an investigation summary, along with all supporting documentation, is forwarded to the Exchange with a recommendation that the Exchange review the matter for possible violations of Exchange rules.
- NFA's inquiry reports, which summarize the facts of an inquiry if NFA staff decides to close an inquiry administratively, are well researched and effectively state NFA's reasons for closing each inquiry. While these reports are satisfactory and the Exchange's CRO was generally kept informed about the status and result of all inquiries, the Division found that, during the target period, the Exchange's CRO did not review these inquiry reports as part of his routine monitoring of NFA's regulatory services.
- NFA's inquiry reports and investigation summaries clearly state how each matter was initiated and how the facts were developed during the course of the inquiry or investigation. Requests for information from market participants were well documented and were incorporated into the case files in an organized manner. NFA's investigative work is thorough and its documentation with respect to each matter is complete.
- When the CRO decides not to pursue disciplinary action against the subject of an investigation that has been referred to him by NFA, he will include a close-out memorandum stating his decision in the investigatory file. During the target period, the

close-out memoranda prepared by the CRO failed to sufficiently explain the basis of his decisions not to take disciplinary action against the subjects of investigations.

- NFA and NYSE Liffe maintain detailed inquiry and investigation logs. However, during the target period, these logs did not adequately denote the time between an exception's initial identification by NFA and its official designation as an inquiry. This was particularly true for those inquiries that did not originate from NFA's program of random review of omnibus accounts. In this report, the time between an exception's initial identification and its official designation as an inquiry is referred to as the "pre-inquiry" stage.⁴
- During the target period, most inquiries conducted by NFA originated from NFA's program of random review of possible wash trading through omnibus accounts.
- The Division found that a prolonged and unexplained period of time consistently elapsed between the date when NFA sent an investigation report to the Exchange and the date when the CRO made a final determination regarding the investigation, including closing it with no further action or referring the matter to a disciplinary committee.
- The Division found the NFA's investigative work to typically be thorough and complete. In addition, the Division found that NYSE Liffe's decision whether or not to pursue disciplinary action against a market participant was typically appropriate.
- During the target period, the Exchange inappropriately permitted a market participant with significant trading volume to continue using an automated trading system whose trading behavior resulted in apparent violations of Exchange rules. In addition, the Exchange's participation in NFA's investigation of the matter, including efforts to intermediate discussions between NFA and the market participant, may have delayed NFA's investigatory process.

B. Recommendations

Although the Division believes that NYSE Liffe maintains an adequate trade practice surveillance program, the Division identified areas for improvement and is making the following recommendations:

- NYSE Liffe's ROC should monitor the Compliance Department's workload and responsibilities outside of compliance, including those of the CRO, to ensure that they do not detract from the Compliance Department's timely and effective performance of its self-regulatory responsibilities, especially in light of the dramatic increase in trading volume at the Exchange.

⁴ The Division notes that after the target period the CRO took additional steps to track matters in this "pre-inquiry" stage.

- NFA and NYSE Liffe should undertake a comprehensive review of NFA staff and other resources devoted to trade practice surveillance at the Exchange to determine whether such resources are sufficient for the Exchange's current volume levels. At the conclusion of such review, NFA and NYSE Liffe should report to the Division concerning the review process, the factors considered, the conclusions reached, the reasons why they believe that NFA's present staff levels are adequate or need improvement, and any actions taken or planned in response to the review.
- NYSE Liffe's CRO should receive and promptly review reports of all inquiries closed by NFA to monitor the sufficiency of NFA's inquiry process and the adequacy of NFA's substantive determinations.⁵
- NYSE Liffe close-out memoranda for any investigation referred by NFA and closed administratively by the Compliance Department should provide additional information sufficient to explain any final action taken with respect to the investigation (*i.e.*, action other than referral to any disciplinary committee or remittal to NFA for further work).
- All logs maintained by NFA should note the date of the initial trade exception or other activity that led to an inquiry or an investigation.
- NFA should periodically provide NYSE Liffe with a log of all matters in the pre-inquiry stage.
- NFA should increase the number of proactive reviews it conducts with respect to NYSE Liffe markets.
- NYSE Liffe should reduce the time it takes to review and take action with respect to completed investigations referred by NFA.
- NYSE Liffe should require market participants whose automated trading systems or algorithms result in trading patterns that are indicative of apparent violations of Exchange rules to discontinue the use of such systems or algorithms until the cause of the apparent violations is identified and remedied.
- NYSE Liffe should ensure that its participation in NFA's investigations of potential Exchange rule violations, including any intermediation of discussions between NFA and Exchange market participants, does not delay NFA's investigatory process.

⁵ During his interview with the Division, the CRO noted that he planned to begin reviewing reports of all inquiries closed by NFA.

IV. NYSE Liffe Operations

A. Designation as a Contract Market

On March 14, 2008, NYSE Euronext, Inc. (“NYSE Euronext”), an operator of equity and derivatives exchanges in both Europe and the United States, purchased from Chicago Mercantile Exchange Group, Inc. (“CME”) a group of precious metals contracts that were traded on the Board of Trade of the City of Chicago, Inc. (“CBOT”).⁶ Under the terms of the agreement between the two companies, these contracts were to continue trading on CBOT until NYSE Euronext established its own DCM. From June 3, 2008 to August 15, 2008, NYSE Liffe submitted documents to the Commission as part of an application for designation as a DCM. On August 21, 2008, the Commission approved NYSE Liffe’s designation application and also approved the transfer of the metals contracts purchased from CME, along with all open interest associated with these contracts.⁷

On September 8, 2008, NYSE Liffe completed its first day of trading.⁸ Clearing services were provided by CME, which had cleared trades for the precious metals contracts when they were traded on CBOT.⁹ In March 2009, the Exchange transitioned to the Option Clearing Corporation (“OCC”) for clearing services.¹⁰ In the period from September 2009 to November

⁶ NYSE Liffe Overview, NYSE Liffe application for designation as a contract market: <http://www.cftc.gov/stellent/groups/public/@requestsandactions/documents/ifdocs/nyseliffeoverview.pdf>.

⁷ Order of Designation of NYSE Liffe, LLC: <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/nyseliffeletter082108.pdf>.

⁸ On September 8, 2008, NYSE Liffe had the following contracts listed for trading: 100oz. Gold futures, 100oz. Gold futures options, Mini-sized Gold futures, 5000oz. Silver futures, 5000oz. Silver futures options and Mini-sized Silver futures. See <http://www.nyse.com/pdfs/1-2008.pdf>.

⁹ NYSE Liffe Overview *supra* note 6.

¹⁰ The transition to OCC for clearing services was effective March 30, 2009: <http://www.nyse.com/pdfs/04-2009.pdf>.

2010, NYSE Liffe listed for trading a number of MSCI equity index futures products.¹¹ OCC was also selected as clearing service provider for these contracts. OCC continues to perform clearing services for both the MSCI equity index contracts and NYSE Liffe's metals contracts.

NYSE Liffe uses NYSE Euronext LIFFE CONNECT® (“LIFFE CONNECT”) as its trading platform, which is provided and maintained by NYSE Technologies, a division of NYSE Euronext. Exchange trading privileges are open to members and non-member market participants; however, non-member market participants are required to access the market through a member. Members must complete an application process that requires the applicant to meet certain minimum financial requirements and undergo a background check.¹² Members are entitled to discounted rates on Exchange fees.

B. Products and Trading Volume During the Target Period and After

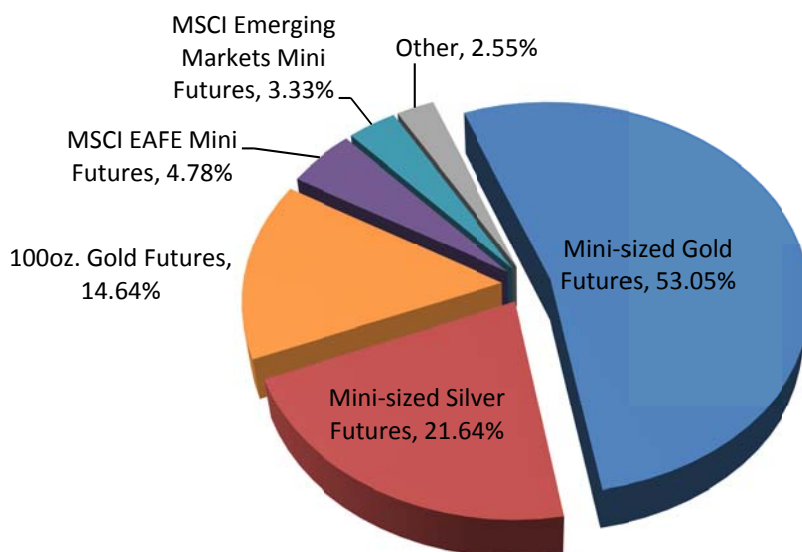
During the target period, five products comprised approximately 97.45 percent of NYSE Liffe's volume: Mini-sized Gold futures accounted for 53.05 percent; Mini-sized Silver futures 21.64 percent; 100oz. Gold futures 14.64 percent; MSCI EAFE Mini futures 4.78 percent; and MSCI Emerging Markets Mini futures 3.33 percent. Figure 1, below, depicts the Exchange's trading volume by contract during the target period.¹³

¹¹ Futures on the MSCI Emerging Markets, MSCI EAFE, and MSCI USA Indices were listed for trading on September 8, 2009: <http://www.nyse.com/pdfs/19-2009.pdf>; futures on the MSCI USA Growth and Value Indices were listed for trading on July 6, 2010: <http://www.nyse.com/pdfs/08-2010.pdf>, futures on the MSCI Europe, MSCI Europe Value, MSCI Europe Growth, MSCI Euro and MSCI Pan-Euro Indices were listed for trading on November 1, 2010: <http://www.nyse.com/pdfs/24-2010.pdf>, <http://www.nyse.com/pdfs/23-2010.pdf>. Effective June 20, 2011, NYSE Liffe become the sole DCM listing futures on the MSCI Emerging Markets and MSCI EAFE Indexes: <http://www.nyse.com/pdfs/15-2011.pdf>.

¹² NYSE Liffe U.S. Membership: <http://www.nyseliffeus.com/sites/liffeus.nyx.com/files/nyseliffeusmembershipapp.pdf>. Financial Requirements for membership are explained in Rules 504 and 505 of the NYSE Liffe Rulebook: <http://www.nyse.com/pdfs/rulebook.pdf>.

¹³ Data in figure 1 were obtained from Commission trading volume statistics.

Figure 1: NYSE Liffe U.S. Percentage of Trading Volume by Contract - During the Target Period



In March 2011, after the target period of this rule enforcement review, NYSE Liffe listed for trading a number of U.S. Treasury and Eurodollar futures products.¹⁴ These products are cleared through New York Portfolio Clearing, a joint venture between NYSE Euronext and The Depository Trust & Clearing Corporation (“DTCC”), which was approved for registration as a Derivatives Clearing Organization (“DCO”) by the Commission on January 31, 2011.¹⁵ New York Portfolio Clearing employs a unique methodology for determining margin by cross-margining the futures positions of market participants against certain securities and repurchase

¹⁴ Three month Eurodollar futures were listed for trading on March 21, 2011, U.S. Treasury futures were listed for trading on March 28, 2011: <http://www.nyse.com/pdfs/05-2011.pdf>.

¹⁵ NYSE Liffe US Clearing Page: <http://www.nyseliffeus.com/clearing> and Order of Registration of New York Portfolio Clearing, LLC: <http://www.cftc.gov/stellent/groups/public/@requestsandactions/documents/ifdocs/nypcregistrationorder.pdf>.

agreements that are cleared by DTCC's subsidiary, Fixed Income Clearing Corporation.¹⁶ The Exchange believes that this cross-margining, which New York Portfolio Clearing refers to as "one-pot" margining, allows market participants to more efficiently manage their capital and market risk.

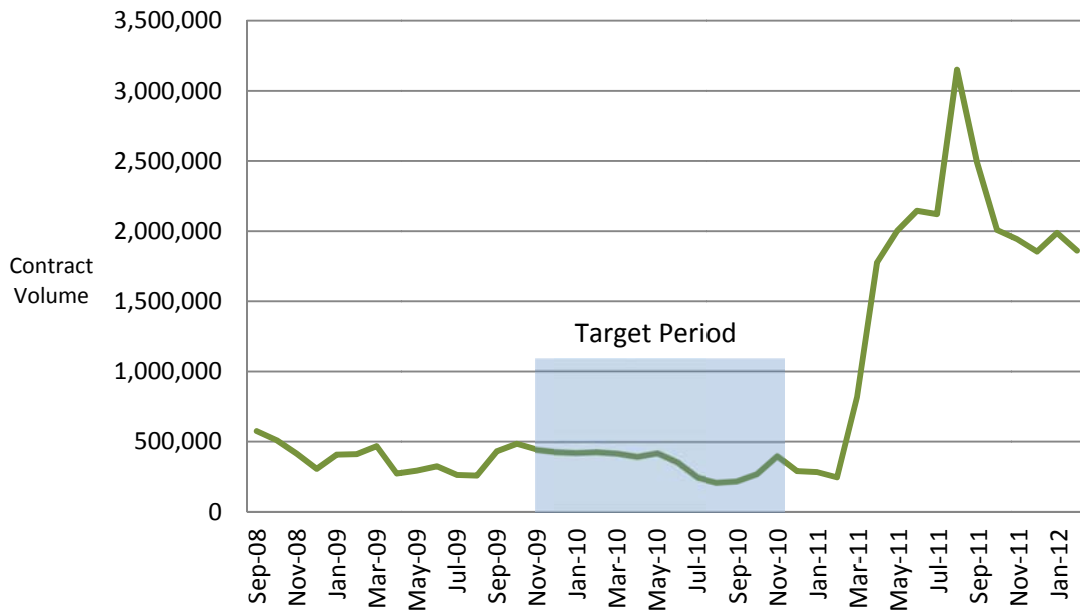
From the time of its launch on September 8, 2008 until March of 2011, NYSE Liffe's aggregate trading volume remained relatively stable. Monthly trading volume averaged 354,474 contracts during the target period (including both options and futures volume). NYSE Liffe was the ninth largest U.S. futures exchange, by volume, in 2010. However, because U.S. futures volume is highly concentrated at the largest exchanges, NYSE Liffe accounted for only .15 percent of total U.S. futures trading volume in 2010.

As depicted in Figure 2 below, trading volume at the Exchange increased significantly beginning in March of 2011.¹⁷ Most recently, trading volume during the month of February 2012 reached almost two million contracts. This large increase in volume was primarily driven by Eurodollar and U.S. Treasury futures products listed by the Exchange in late March 2011, catapulting NYSE Liffe to the fifth largest U.S. futures exchange by volume in 2011. However, even with this increase, the Exchange's volume only accounted for approximately .68 percent of U.S. futures trading volume in 2011.

¹⁶ New York Portfolio Clearing – About NYPC: <http://www.nypclear.com/about>.

¹⁷ Data in figure 2 were obtained from Commission trading volume statistics.

Figure 2: NYSE Liffe U.S. Monthly Trading Volume Since Inception

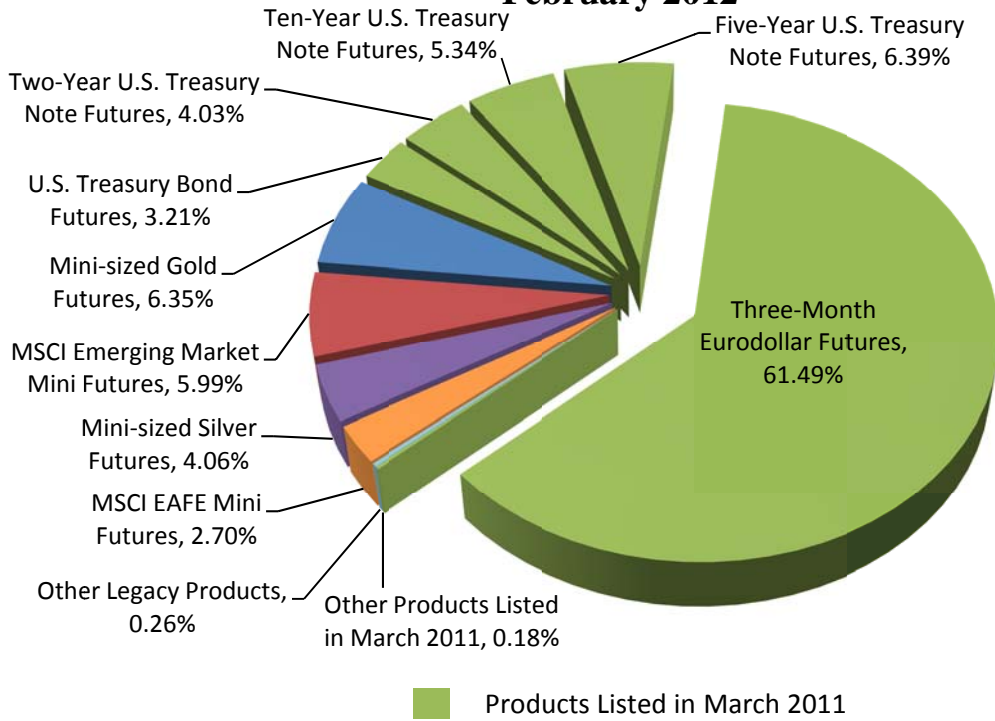


Since their listing, Eurodollar and U.S. Treasury futures have become the Exchange’s dominant products, accounting for approximately 80 percent of the Exchange’s February 2012 trading volume.¹⁸ Products already offered for trading prior to March 2011 have been displaced as major Exchange contracts. For example, Mini-sized Gold futures, which made up 53.05 percent of NYSE Liffe’s trading volume during the target period, accounted for only 6.35 percent of the Exchange’s volume in February 2012. Figure 3 below, compares the share of Eurodollar, Treasury, and other contracts traded at NYSE Liffe in February 2012.¹⁹

¹⁸ Includes Three-Month Eurodollar futures, Ten-Year U.S. Treasury Note futures, Five-Year U.S. Treasury Note futures, Two-Year U.S. Treasury Note futures, U.S. Treasury Bond Futures, and Ultra U.S. Treasury Bond Futures.

¹⁹ Data in figure 3 were obtained from Commission trading volume statistics.

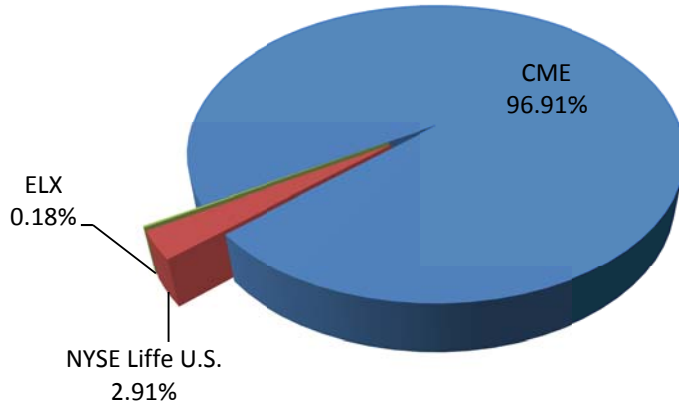
Figure 3: NYSE Liffe U.S. Percentage of Trading Volume by Contract - February 2012



Finally, although Eurodollar futures accounted for the majority of NYSE Liffe’s volume in February 2012, NYSE Liffe’s share of the domestic Eurodollar futures market is relatively small. As depicted in Figure 4 below, NYSE Liffe accounted for 2.91 percent of the Three-Month Eurodollar trading volume in February 2012 while ELX accounted for .18 percent and CME accounted for 96.91 percent.²⁰

²⁰ Data in figure 4 were obtained from Commission trading volume statistics.

Figure 4: Three Month Eurodollar Market Share - February 2012 (based on trading volume)



C. NYSE Liffe Governance

1. Ownership and Board of Directors

NYSE Liffe is a wholly owned subsidiary of NYSE Liffe Holdings, LLC (“Holdings”). At the time of the Exchange’s designation as a contract market in 2008, Holdings was a wholly owned subsidiary of NYSE Euronext. In March 2010, a minority portion of Holdings was sold to six market participants: Citadel Tactical Investments LLC, DRW Ventures LLC, GETCO Strategic Investments LLC, Goldman Sachs & Co., Morgan Stanley Fixed Income Ventures Inc. and UBS Americas, Inc.²¹ As a result, Holding’s board of directors is structured so that each of these six owners is entitled to appoint one director and NYSE Euronext is entitled to appoint the remaining seven directors. In turn, the Exchange’s board of directors (the “Board”) includes all of Holdings’ directors plus sufficient public directors to ensure that it meets the Commission’s

²¹ NYSE Liffe U.S. Completes Sale of Ownership Stake to Leading Market Participants: <http://www.nyse.com/pdfs/newsrelease031010.pdf>.

guidance on DCM board composition (*i.e.*, at least thirty-five percent public directors).²²

Currently, the Board consists of nineteen directors, with seven who qualify as public directors (approximately 37 percent of the total number of directors).

2. Regulatory Oversight Committee

NYSE Liffe's self-regulatory program is overseen by the Exchange's ROC, which is a committee of the Board made up of three of the Exchange's seven public directors. ROC members are appointed by the Board and, as public directors, may only be removed by a majority vote of the Board. The members of the ROC do not have a fixed term and serve until their successor is appointed, they resign, or they are removed. The ROC's duties are to: "(i) provide independent oversight of core regulatory functions, including trade practice, market and financial surveillance, (ii) assist the Board in minimizing potential conflicts of interests of NYSE Liffe with the goal that the core regulatory functions enable the Board to administer effectively NYSE Liffe's self-regulatory obligations, and (iii) ensure that core regulatory functions are fair and impartial to all NYSE Liffe members."²³ As part of these duties, the ROC must annually prepare a report that evaluates the effectiveness of the Exchange's self-regulatory program. In furtherance of these duties, the ROC has considerable authority to review Exchange

²² The Acceptable Practices for Core Principle 15 of the CEA state that "[a]t least thirty-five percent of the directors on a contract market's board of directors shall be public directors."

²³ NYSE Liffe ROC Charter. The ROC charter also includes a more detailed list of responsibilities, which states that the ROC shall: (1) "monitor NYSE Liffe's regulatory program for sufficiency, effectiveness and independence"; (2) "oversee all facets of the regulatory program as performed by [NFA]"; (3) "review the size and allocation of regulatory budgets and resources; and the number, hiring, termination and compensation of NYSE Liffe's regulatory officers and staff"; (4) "identify aspects of the regulatory scheme that work well and those that need improvement, and, as necessary, make recommendations to the Board for changes that would ensure fair and effective regulation"; (5) "supervise NYSE Liffe's chief regulatory officer, who will report directly to the Committee"; (6) "keep minutes and records of its meetings, deliberations and analyses, including records of all decisions made by the [ROC] and any disagreements within the [ROC] with respect to such decisions"; (7) "review such other matters and perform such additional activities, within the scope of its responsibilities, as the Board deems necessary or appropriate"; and (8) "review changes (or proposed changes, as appropriate) to NYSE Liffe's rules to the extent that such rules are likely to impact significantly the self-regulatory functions of NYSE Liffe."

documentation and independently consult with, and interview, staff of NYSE Liffe and NFA, the Exchange's regulatory service provider. Additionally, the ROC also has the authority to retain independent legal counsel and other professional services.²⁴

The CRO meets with the ROC at least four times a year to give the committee a formal presentation about the status of the compliance function. These presentations summarize the activities performed for the Exchange by NFA and highlight the status of any pending inquiries, investigations and disciplinary proceedings. The ROC also plays an integral part in setting the budget for the Compliance Department. The CRO makes an annual budget recommendation to the ROC. The ROC reviews the CRO's budget recommendations and makes a recommendation to the full board. The Compliance Department's budget is approved by the Board as part of the Exchange's overall budget.

D. Regulatory Services Provided by NFA

As mentioned above, NYSE Liffe has contracted with NFA to receive certain regulatory services. In particular, NFA performs trade practice and market surveillance on NYSE Liffe's markets, as well as most of the investigatory work relating to trade practice and market surveillance. NFA also conducts background checks on potential members in connection with the processing of new membership applications. Additionally, NFA provides an arbitration forum for the resolution of customer vs. NYSE Liffe member disputes and NYSE Liffe member vs. member disputes. Real-time monitoring of trading on the Exchange's markets is not

²⁴ *Id.* The ROC Charter states that the ROC has the authority to "(i) conduct its own inquiries; (ii) consult directly with regulatory staff of NYSE Liffe and the National Futures Association; (iii) interview employees, officers and members of NYSE Liffe; (iv) review all relevant documents; (v) retain independent legal counsel, auditors and other professional services; and (vi) otherwise exercise its independent analysis and judgment to fulfill its regulatory obligations."

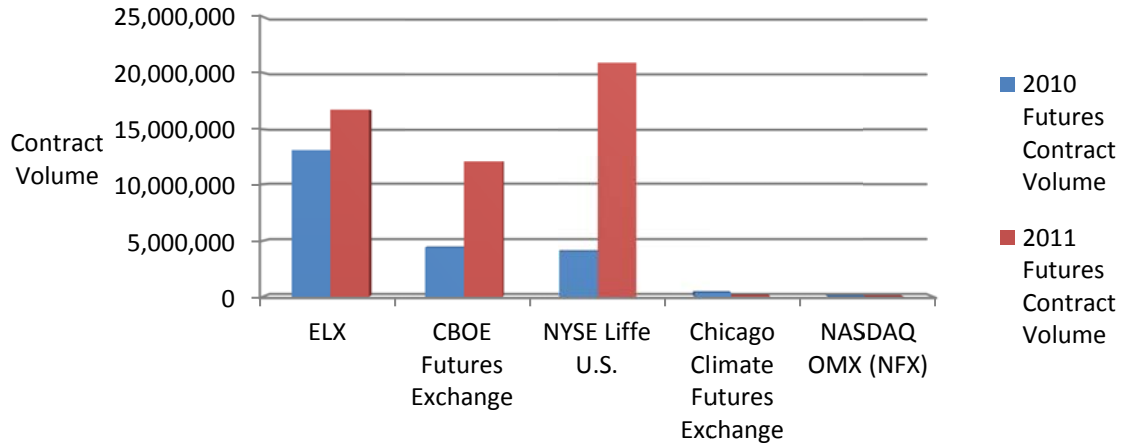
performed by NFA, but is instead conducted by employees of NYSE Liffe Administration and Management.²⁵

During the target period, NFA provided similar services to ELX Futures, CBOE Futures Exchange, Chicago Climate Futures Exchange, and NASDAQ OMX Futures Exchange. Among exchanges utilizing NFA for regulatory services in 2010, NYSE Liffe was the third largest exchange by volume, trading approximately four million futures contracts. As noted previously, however, NYSE Liffe's trading volume increased dramatically in 2011. As depicted in Figure 5 below, in 2011 the Exchange became the largest exchange, by volume, receiving regulatory services from NFA.²⁶

²⁵ Further information on real-time market monitoring by NYSE Liffe can be found on pages 18-19.

²⁶ On December 31, 2010, the Chicago Climate Futures Exchange transitioned to IntercontinentalExchange for regulatory services. Therefore, its trading volume for 2011 was not included in figure 5. In 2011, NFA also began providing regulatory services for Eris Exchange. Since Eris Exchange was designated as a DCM on October 28, 2011, its trading volume was also not included in figure 5. Data in figure 5 for ELX, CBOE Futures Exchange, NYSE Liffe, and Chicago Climate Futures Exchange were obtained from Futures Industry Association monthly volume and open interest reports. Data in figure 5 for NASDAQ OMX were obtained from Commission trading volume statistics.

Figure 5: 2010 and 2011 Futures Trading Volume of Exchanges Using NFA for Regulatory Services



V. Trade Practice Surveillance Program

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.

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.

Pursuant to Appendix B to Part 38 of the Commission's regulations, a contract market's trade practice surveillance program should have the arrangements, resources, and authority necessary to perform effective rule enforcement. The arrangements and resources attendant to the program should facilitate the direct supervision of the contract market, including analysis of relevant data. Trade practice surveillance programs can be carried out by the contract market itself or through delegation to a third party.

An acceptable program should have systems that maintain all data reflecting the details of each transaction executed on the contract market. In this regard, the program should include routine electronic analysis of transaction data to detect potential trading violations. The program should also provide for appropriate and thorough investigation of potential trading violations brought to the contract market's attention, including member and Commission referrals and customer complaints.

A. Compliance Staff

1. Exchange Compliance Department Staff

During the target period, NYSE Liffe's Compliance Department consisted of two dedicated staff members, the CRO and a consultant who spent approximately two-thirds of his time working on Exchange functions and a third of his time performing services for New York

Portfolio Clearing, a DCO affiliated with the Exchange. After the target period, the consultant was appointed Deputy CRO. The Compliance Department also includes an analyst that spends half of his time with the Compliance Department. The CRO and the Deputy CRO are both attorneys with many years of experience in compliance and with the CEA and Commission regulations. The CRO's responsibilities include overseeing the Exchange's compliance program and managing NFA as a provider of regulatory services. In addition to his compliance duties, the CRO provides advice to the Exchange relating to the CEA, Commission regulations, and other applicable laws and regulations. He also prepares new contract and rule filings for submission to the Commission and occasionally assists with legal work in other areas. The Deputy CRO assists the CRO with these duties.

The Exchange does not have a general counsel, but receives legal services from NYSE Euronext's legal department. The CRO reports to the ROC, but for administrative matters the CRO is overseen by the CEO of NYSE Regulation, Inc., a not-for-profit organization that performs market regulatory functions for NYSE Euronext's national securities exchanges.²⁷ The CRO's compensation and employment tenure are determined by the ROC.

London-based staff of Liffe Administration and Management conducts NYSE Liffe's real-time market monitoring. This London staff consists of approximately twenty-five people that cycle between NYSE Liffe and other exchanges operated by NYSE Euronext. Each Liffe Administration and Management staff member that conducts real-time market monitoring for the Exchange has signed a secondment agreement in which they agree to work under the control and direction of the Exchange's CRO or its Chief Operating Officer when conducting NYSE Liffe real-time market monitoring. While these personnel report to the Exchange's CRO or Chief

²⁷ NYSE Euronext's national securities exchanges include New York Stock Exchange LLC, NYSE Amex LLC, and NYSE Arca, Inc.

Operating Officer when performing this real-time market monitoring function, they remain Liffe Administration and Management employees.

2. NFA Compliance Staff and Coordination with NYSE Liffe

NFA is managed on a day-to-day basis by a twelve-member Executive Committee comprised of the NFA's President and eleven members of NFA's Board. NFA trade practice surveillance is handled by the Trade Practice and Market Surveillance Group.²⁸ TPMS has a vertical structure: analysts and senior analysts are overseen by a manager, who is overseen by a senior manager. TPMS is headed by an Associate Director.

During the target period there was a pool of five analysts and senior analysts to oversee the exchanges for which NFA conducted trade practice surveillance, including NYSE Liffe. Although NFA does not have a formal compliance manual to detail the procedures NFA staff must follow while conducting trade practice surveillance, the Division found that NFA's staff members are highly qualified and well trained.²⁹ Each new TPMS employee receives four to eight weeks of training. This training includes, among other things, a review of NFA's regulatory service agreements with exchanges, a review of NFA's trade practice exception reports, a review of NFA's internal procedures, a review of specific contract specifications, and familiarization with exchange rules.³⁰ New staff will also spend time observing an analyst or senior analyst during performance of trade practice and market surveillance analysis.

²⁸ After the target period TPMS was renamed Market Regulation.

²⁹ While NFA does not have a single comprehensive document that could be considered a compliance manual, it has a number of documents that, taken together, detail the procedures that NFA staff must follow while conducting trade practice surveillance. The Division believes that these documents should be compiled into a formal compliance manual.

³⁰ NFA's automated surveillance system generates trade practice exception reports when trading behavior exhibits suspicious patterns or breaches pre-programmed parameters. These exceptions identify potential violative conduct and alert NFA staff to matters that require further review. Further information on automated surveillance by NFA can be found on pages 21-23.

Additionally, NFA cross-trains analysts so they are familiar with the rules of each exchange for which NFA provides regulatory services.

Each exchange for which NFA conducts trade practice surveillance is assigned a primary analyst. While each primary analyst typically conducts trade practice and market surveillance for the exchange they are assigned, on any given day any one of the other analysts, senior analysts, or managers could be called upon to conduct trade practice and market surveillance. The primary analyst assigned to NYSE Liffe is highly qualified and has considerable experience. Typically, the primary NYSE Liffe analyst spends approximately eight to eight and a half hours per day reviewing exceptions and doing casework for NYSE Liffe. Time spent by the rest of the TPMS group on NYSE Liffe matters varies. On a typical day, a manager will review the primary NYSE Liffe analyst's work as will a senior manager. Other analysts may assist with investigations and perform daily surveillance if the primary NYSE Liffe analyst is out of the office or has other work to complete.

NFA and its staff interact regularly with the Exchange's Compliance Department to keep it informed of any issues related to the regulatory services provided. Each month NFA sends NYSE Liffe two reports. One report includes all exceptions by type. The second report is a log which includes current formal inquiries and investigations that are open on behalf of NYSE Liffe. NFA also conducts formal meetings with NYSE Liffe once a month to discuss any new market makers, changes to existing incentive programs, new incentive programs, outstanding inquiries/investigations, the monthly reports submitted to the Exchange, new Exchange business (*e.g.*, product launches), compliance issues raised by either party, as well as any other items of note. NFA and the Exchange's Compliance Department staff are also regularly in contact

several times each week, either via email or phone, and if required, daily. Additionally, the CRO is included in all emails in which NFA requests information from a market participant.

Recommendations with Respect to Compliance Staff

NYSE Liffe maintains a small but highly experienced staff in its Compliance Department. However, all staff members have meaningful responsibilities outside of the Compliance Department. The Exchange experienced significant volume growth in 2011. This growth, combined with the Compliance Department's small size and outside responsibilities, raises concerns about the sufficiency of Compliance Department resources at NYSE Liffe. The Division believes that the Compliance Department could become overburdened, especially if the Exchange continues its current rate of growth. Accordingly, **the Division recommends that:**

- **NYSE Liffe's ROC monitor the Compliance Department's workload and responsibilities outside of compliance, including those of the CRO, to ensure that they do not detract from the Compliance Department's timely and effective performance of its self-regulatory responsibilities, especially in light of the dramatic increase in trading volume at the Exchange.**

The Division believes that the number of NFA staff assigned to NYSE Liffe was sufficient during the target period. However, given the Exchange's increasing volume, the Division is concerned about NFA's continued ability to conduct effective trade practice surveillance for NYSE Liffe with a single primary analyst. Accordingly, **the Division recommends that:**

- **NFA and NYSE Liffe undertake a comprehensive review of NFA staff and other resources devoted to trade practice surveillance at the Exchange to determine whether such resources are sufficient for the Exchange's current volume levels. At the conclusion of such review, NFA and NYSE Liffe should report to the Division concerning the review process, the factors considered, the conclusions reached, the reasons why they believe that NFA's present staff levels are adequate or need improvement, and any actions taken or planned in response to the review.**

B. Automated Surveillance System

NFA's primary trade practice surveillance tool is an alert and analysis program called the Trade Analysis and Profiling System ("TAPS"). TAPS was developed internally by NFA and features a variety of flexible analysis tools within one integrated system. TAPS generates trade practice exception reports when trading behavior exhibits suspicious patterns or breaches pre-

programmed parameters. These exceptions identify potential violative conduct and alert NFA staff to matters that require further review. TAPS functions with order and trade data provided daily to NFA by the Exchange, typically no later than four hours after the end of a trading session.

The exception reports generated by TAPS are catalogued according to the violations they are designed to detect. Common reports include, for example, the Simple Wash Trade Report, the Direct Cross Report, the Money Pass Report, and the Counter Party Trade Percentage Report. Through such reports and others, TAPS can detect wash trading, direct and indirect crossing of orders, and other possible violations of Exchange rules. The TAPS exception reports are generated and reviewed daily, typically on the business day after the trade occurred (T+1). NFA staff's review of exceptions is aided by a suite of TAPS tools that permit detailed analysis of trades, traders, trading patterns, and relationships. In addition to automated exception reporting, NFA also uses TAPS to conduct customized "pro-active" reviews of audit trail data. For example, staff has the flexibility to tailor queries based on the time of a transaction, order type, quantity, price, etc. Once NFA staff move beyond their initial review of an exception to a more detailed examination of potential trading abuses, this ability to organize and mine trade data greatly facilitates staff's research and analysis.

Another important TAPS function is the "trader profile," which provides NFA with the key characteristic practices of specific traders. Trader profiles include average number of trading days per month, frequency of trading, average trade size, profit and loss history, frequent counterparties, and percentage of total volume in a given market. These trader profiles allow NFA to notice deviations from a trader's profile, such as those involving unusual profit patterns,

significant trading volume changes, unusual concentrations of trading activity between the same counterparties, and unusual error account activity.

TAPS also includes a “notes” function that allows NFA staff and supervisors to document and track their surveillance work. The notes function also enables the NFA staff that reviews exception reports to dismiss trade exceptions administratively. In such instances, the notes function provides the place for electronic documentation to record an administrative closure if staff deems an exception not to be indicative of a trading violation. Notes can be reviewed by NFA supervisors and other staff members who need to consult them for their reviews.

Division staff reviewed TAPS’ tools and output in the course of this review, and has reviewed TAPS in the course of previous rule enforcement reviews and applications for designation by other exchanges using NFA for regulatory services. The Division believes that TAPS is sufficient to assist NFA staff to monitor trading on the Exchange, examine potential violations, and track and supervise compliance work as it progresses. Accordingly, the Division has no recommendations in this area.

C. Trade Practice Inquiry and Investigation Process

1. NFA’s Review of Trading Activity

NFA staff reviews TAPS exception reports daily. NFA staff can dismiss an exception immediately, with appropriate electronic documentation through TAPS’ notes function, if it deems the exception unfounded. Some exceptions require further information before a decision is made either to close that exception administratively or to open it as an inquiry. If NFA staff believes that further information is required, the exception will remain open while information is solicited or further monitoring is performed. During this time, NFA staff uses the TAPS notes

function to document the information they have gathered to establish a possible pattern of violative trading. While not formally designated by NFA or the Exchange, this open period may be referred to as a “pre-inquiry” stage. The notes created during this pre-inquiry stage are visible to all NFA staff and managers so a staff member monitoring an exception in the pre-inquiry stage can be advised if any other NFA staff observe a related trade exception. The additional monitoring in the pre-inquiry stage will provide information to confirm whether or not the initial exception was isolated in nature and unintentional or whether a formal “inquiry” should be opened. Many exceptions in the pre-inquiry stage are eventually closed without being raised to the status of a full inquiry.

If NFA determines that an exception requires further scrutiny, it will then initiate an inquiry. NFA may open inquiries, and close them administratively, without prior Exchange approval. Inquiries may also be initiated by means other than through exception reports. NFA periodically conducts "pro-active" reviews to detect potentially abusive trading activity. These pro-active reviews include an analysis of a trader's entire audit trail of activity, as opposed to just the activity surrounding a specific trade exception.

If an inquiry reveals potential violations of Exchange rules, then a formal “investigation” may be opened. Under the RSA, if NFA believes that an inquiry should become a formal investigation, NFA staff will contact the CRO to explain the results of its inquiry and make a recommendation to open an investigation. The CRO will then make a determination as to whether further investigation is necessary. If the CRO declines to follow NFA’s recommendation, the RSA requires that he notify NFA in writing and provide an explanation for the decision.

In practice, the transition from inquiry to investigation appears to be less formal than described in the RSA. In instances where the facts and evidence do not support opening an investigation, NFA will close the inquiry administratively with no action. If NFA believes that there may be a potential violation of Exchange rules, the inquiry will be designated as an investigation and will be referred to the Exchange for review along with an investigative summary and the supporting documentation that forms the basis of NFA's findings. Typically, NFA refers investigations to the Exchange the same day they are formally designated as investigations.

One of the characteristics that distinguishes matters designated by NFA as inquiries from matters designated as investigations is that NFA may close inquiries administratively without Exchange approval. If an inquiry does not develop into an investigation and is closed administratively by NFA with no action, an inquiry report is created that details NFA's review of the relevant facts. In contrast, all matters designated as investigations are referred to the CRO along with an investigative summary and a recommendation that the Exchange review the matter for possible violation of Exchange rules.

During the target period, the CRO did not receive a copy of NFA's inquiry reports. Instead, the Exchange was informed through email or over the phone that an inquiry was closed and received a brief description as to why it was closed. Division staff reviewed all ten inquiry reports created by NFA during the target period that explain NFA staff's decision to close an inquiry administratively with no further action. While the Division believes that these reports are satisfactory, the Division is concerned that the CRO did not review them.

2. Exchange Review of NFA Investigations

At the conclusion of an investigation NFA prepares a written report summarizing its findings and presents this report to NYSE Liffe's CRO along with the supporting documentation that forms the basis of NFA's findings. Once the investigative summary is received by the CRO, he will make the final decision as to what action, if any, will be taken. The CRO may forward the report to an NYSE Liffe disciplinary committee, close an investigation without referral to a disciplinary committee, or remit the matter back to NFA for further investigation. If the CRO decides to close an investigation without referral to a disciplinary committee, the CRO will draft a memorandum explaining his decision. These close-out memoranda typically contain a brief description of why the Exchange chose to close the relevant investigation, such as insufficient evidence or lack of jurisdiction.

During the target period, the Exchange closed six trade practice investigations that had been referred to it by NFA with a recommendation for review for possible violations of Exchange rules. Of these, two investigations were closed by the Compliance Department with no action and four were closed by the Exchange through the issuance of a warning letter to the investigated party. Division staff reviewed the investigation files for all six investigations closed during the target period. Division staff also reviewed both close-out memoranda drafted by the CRO during the target period.

In general, the Division believes that the explanations provided in the CRO's close-out memoranda do not fully explain the CRO's reasoning for his final determination. For example, in one instance during the target period, the CRO closed an investigation due to a lack of evidence. The close-out memorandum for this investigation consisted of two sentences. One of these sentences simply stated that the CRO was closing the matter without further action. The

other, in explaining the decision, stated that “[t]he basis for this determination, among other things, is the lack of evidence of one of [sic] more violations of NYSE Liffe US Rules subject to the Exchange’s jurisdiction, and considering the evidence in the best light possible from the aspect of a prosecution for violation of Exchange’s rules, the de minimis nature of the activity.” The Division believes that limited explanations such as these are not sufficient. If there was a lack of evidence, the CRO should have explained in his closing memoranda why the evidence presented was insufficient to prove a violation of the rules cited by NFA in its investigation report. In instances where the CRO believes that the Exchange does not have jurisdiction over the market participant, the CRO should set forth the reasons why the Exchange does not have jurisdiction.

Recommendations with Respect to Inquiry and Investigation Process

The Division is concerned that, during the target period, the Exchange’s CRO did not review inquiry reports detailing NFA’s review of inquiries that did not develop into investigations. The Division believes that the CRO cannot effectively evaluate whether or not NFA staff is correct in its decisions to close matters administratively if he does not review the final report of inquiries that do not become investigations. Accordingly, **the Division recommends that:**

- **NYSE Liffe’s CRO receive and promptly review reports of all inquiries closed by NFA to monitor the sufficiency of NFA’s inquiry process and the adequacy of NFA’s substantive determinations.**

The Division is also concerned that during the target period the CRO’s close-out memorandum provided only a limited explanation of his reasoning for his final determination to close an investigation with no action. Accordingly, **the Division recommends that:**

- **NYSE Liffe close-out memoranda for any investigation referred by NFA and closed administratively by the Compliance Department provide additional information sufficient to explain any final action taken with respect to the investigation (*i.e.*, action other than referral to any disciplinary committee or remittal to NFA for further work).**

D. Inquiry and Investigation Logs

NFA maintains a log detailing all inquiries and investigations at NYSE Liffe, including all inquiries not closed or escalated to an investigation. This log is sent monthly to the Exchange and allows it to determine whether inquiries are resolved in a timely manner. However, in a number of inquiries, Division staff noticed prolonged periods between the dates when NFA staff were first alerted to potentially violative activity, and the dates NFA formally opened an inquiry. These periods correspond to the periods in which each matter was in the pre-inquiry stage, as described above. Since the time spent in the pre-inquiry stage varies with each inquiry and investigation, and is not accounted for in NFA's log, the log does not fully reflect the time that NFA spent investigating a matter. As a consequence, it may be difficult for the CRO or Division staff to evaluate the timeliness of an inquiry or investigation conducted by NFA.

In discussions with Division staff, the CRO has noted that he is taking steps to enhance his understanding and use of NFA's log. In particular, the CRO is taking additional steps to track any outstanding exceptions identified by NFA that have not been closed administratively by NFA or that have not become inquiries within thirty days after generation. The Division supports the efforts of the CRO in this regard and believes that a proper accounting of this pre-inquiry stage is necessary for the Exchange to effectively oversee the regulatory services provided by NFA.

Recommendations with Respect to Inquiry and Investigation Logs

The Division recommends that:

- **All logs maintained by NFA note the date of the initial trade exception or other activity that led to an inquiry or an investigation.**

- **NFA periodically provide NYSE Liffe with a log of all matters in the pre-inquiry stage.**

E. Number and Source of Inquiries and Investigations Closed During the Target Period

1. Inquiries Closed by NFA During the Target Period

NFA closed 11 inquiries during the target period. Nine of these 11 inquiries were also opened during the target period and two were opened prior to the target period. Ten of the closed inquiries were closed with no action and one was closed through elevation to an investigation. For the ten inquiries closed with no action, NFA created inquiry reports with a review of the relevant facts. For the inquiry closed through elevation to an investigation, NFA created an investigative summary that included a review of the relevant facts as well as a recommendation that the Exchange review the matter for possible violation of Exchange rules.

Division staff reviewed the inquiry reports of the ten inquiries closed with no action and the investigation summary of the inquiry closed through elevation to an investigation. Most of the 11 inquiries were generated from NFA's exception report process. Of the 11 inquiries, one was generated from the review of a Direct-Cross exception, one was generated from the review of a Firm Versus Firm exception, and eight originated from NFA's random review process for omnibus accounts that were identified in Simple Wash exception reports.³¹ The last of the 11 inquiries was generated from a pro-active review of trader activity. As described above, in these pro-active reviews, NFA staff conduct customized queries of audit trail data to detect activity that potentially violates Exchange rules.

³¹ In its random review process for omnibus accounts, NFA identifies Simple Wash exceptions generated from its automated surveillance system that involve omnibus accounts. At the end of each month, to determine whether parties to trades identified in the Simple Wash exception reports are actually two separate accounts, NFA randomly selects a number of these exceptions for review to determine who has ownership and control of the underlying accounts connected to the omnibus account. These random reviews constitute the principal means by which NFA conducts trade practice surveillance of omnibus accounts' compliance with Exchange rules.

2. Investigations Closed by the Exchange During the Target Period

During the target period, the Exchange closed six trade practice investigations that had been referred to it by NFA. These six investigations involved the investigation of eight separate parties.³² One of the investigations closed was the investigation that NFA had elevated from an inquiry during the target period. The other five investigations were referred by NFA prior to the target period. Of the six investigations closed by the Exchange during the target period, two were closed by the Compliance Department with no action and four were closed through the issuance of a warning letter. In one of the investigations closed with no action, the Exchange determined that it did not have jurisdiction over the investigated party and referred the investigated party to the Commission and other regulators for further action. In the other, the Exchange closed the matter with no action due, in part, to a lack of evidence.

Recommendation with Respect to Number of Inquiries and Investigations

Division staff is concerned that NFA conducts very few inquiries that originate from sources other than NFA's program of random review of omnibus accounts. In particular, the Division is concerned about the low number of pro-active inquiries. As mentioned above, NFA closed only one pro-active inquiry during the target period. Pro-active reviews are potentially an effective tool for identifying trading practices that violate Exchange rules and Division staff believes that NFA should utilize this tool more often. Accordingly, **the Division recommends that:**

- **NFA increase the number of pro-active reviews it conducts with respect to NYSE Liffe markets.**

F. Timeliness of Inquiries and Investigations

NFA opened thirteen trade practice inquiries during the target period. While only nine of the inquiries opened during the target period were closed by the end of the target period, none of

³² One of the parties appeared in three separate investigations.

the inquiries that were still open at the end of the target period were open for longer than a year.³³ In addition to the nine inquiries opened and closed during the target period, NFA also closed two additional inquiries during the target period that were opened prior to the target period. All eleven inquiries closed by NFA during the target period, either with no action or through elevation to investigation, were closed by NFA within a year from the time they were initiated.

As mentioned above, the Exchange closed six investigations during the target period. One of the investigations closed was the investigation that NFA referred to the Exchange during the target period. The other five investigations were referred by NFA to the Exchange prior to the target period. Of the six investigations closed by the Exchange during the target period, five were closed within six months to a year of when NFA initially opened an inquiry and one was closed over fourteen months after NFA initially opened the inquiry. Division staff examined the investigation files for all six investigations closed by the Exchange during the target period to determine whether they were closed within a reasonable amount of time. Division staff noted a prolonged and unexplained period of time that consistently elapsed between the date when NFA sent the written report explaining the findings of an investigation to the Exchange and the date when the CRO closed the investigation.

In five of the six investigations, including an investigation open for over fourteen months, more than six months elapsed from the time when the Exchange received the written investigative summary from NFA to the date when the CRO either closed the investigation with no action or issued a warning letter. The Division analyzed the investigations for mitigating

³³ The four remaining inquiries initiated during the target period were still in the inquiry stage at the end of the target period and had not been elevated to investigations. As mentioned above, typically NFA will officially designate an inquiry as an investigation the same day it refers the matter to the Exchange with a recommendation that the Exchange review the matter for possible violation of Exchange rules.

factors, including the complexity of the investigation, the number of firms or individuals involved as potential wrongdoers, the number of potential violations to be investigated, and the volume of documents to be examined by the Compliance Department. Based on these factors, the Division believes that these five investigations did not warrant six or more months to resolve from the time they were received by the CRO.

Recommendation with Respect to Timeliness of Inquiries and Investigations

The Division recommends that:

- **NYSE Liffe reduce the time it takes to review and take action with respect to completed investigations referred by NFA.**

G. Adequacy of Inquiries and Investigations

1. Inquiry and Investigatory Work by NFA

Division staff reviewed the inquiry and investigation files, including the inquiry reports and investigative summaries, of all inquiries and investigations closed by NFA during the target period. The Division typically found the quality and documentation of investigative work to be thorough and complete. Questions posed by NFA staff were clear, highly informed, and tightly focused on soliciting information to determine compliance with Exchange rules. Division staff consistently found that NFA staff reviewed documents carefully and used those documents with skill when conducting investigations, writing inquiry reports and investigation summaries, and determining whether or not violations had occurred.

Division staff also observed that pre-inquiries, inquiries, and investigations were well documented. NFA's work product clearly demonstrates NFA staff's analysis and conclusions. Inquiry reports and investigation summaries clearly state how each matter was initiated, how the

facts were developed during the course of the inquiry/investigation, and clearly summarized interviews. Division staff also found that requests for information from market participants were documented and incorporated into the inquiry and investigation files in an organized manner.

2. Review of Investigations by NYSE Liffe

Division staff also reviewed the investigation files of all investigations closed by the Exchange during the target period. In five of the six investigations, the Division found that the Exchange's actions, and its decisions whether or not to pursue disciplinary action, were appropriate. However, the Division believes that the Exchange's actions in one investigation ("Automated Trading Investigation") may have delayed NFA's investigatory process. The Division also believes that the Exchange's response to the actions under investigation was insufficient to ensure immediate compliance with Exchange rules.

As discussed further below, the Automated Trading Investigation involved a market participant that utilized an automated trading system while receiving payments from NYSE Liffe under a trading incentive program based on the volume it transacted on NYSE Liffe. The investigation concerned the significant number of trades the market participant executed against itself. In the period from January 8, 2009 to February 25, 2009, after the Exchange had already been alerted by NFA regarding the large number of trades that the market participant was executing against itself, the market participant executed 16,401 trades with itself for a total of 16,653 contracts. In the thirty-three trade dates in this period, there were twenty-one days where the volume of the market participant's trades with itself was 6 percent or more of NYSE Liffe's total trading volume.

In December of 2008, NFA discovered that this market participant was executing a large number of trades against itself. NFA staff contacted the market participant to investigate the

matter. In its initial response to NFA, the market participant identified the issue as a combination of its trading practices and its trading systems' interaction with NYSE Liffe's trading engine that it claimed resulted in inadvertent trades against itself.

In January of 2009, NFA met with the CRO and discussed this issue. The CRO noted that, in February of 2009, NYSE Liffe had plans to implement a newer version of its LIFFE CONNECT Trading Platform. This newer version was being implemented, in part, to help with the issue the market participant identified in its initial response to NFA. The CRO requested that NFA continue to monitor the market participant with the expectation that the activity would decrease after the implementation of the new version of the trading platform. The Exchange did not require any immediate changes in the market participant's trading practices to address its potentially violative trading activity. Further, NYSE Liffe did not exclude the trades the market participant executed against itself from the volume numbers used to determine the market participant's payments under the incentive program.³⁴

In February of 2009, shortly before the implementation of the new version of the trading platform, NFA asked the Exchange to submit a number of additional questions to the market participant. NFA chose to communicate through the Exchange rather than directly contact the market participant, because during this period of time the Exchange was in direct contact with the market participant and the Exchange appears to have viewed the issue as primarily a technology problem.

In February of 2009, the Exchange implemented the new version of its trading platform. While the number of wash or self-trades executed by the market participant decreased, the

³⁴ In September of 2009, NYSE Liffe began to exclude trades against oneself from the volume numbers used to determine payments under this incentive program.

market participant continued to execute a significant number of trades against itself.

Additionally, NFA did not receive a response to its February 2009 questions until May of 2009, approximately three months after they had first submitted the questions to the Exchange and five months after NFA first detected the trading activity under investigation.³⁵ During this time period, NYSE Liffe was in regular contact with the market participant as the Exchange and market participant attempted to resolve the matter as a technology issue.

In September 2009, although the issue had not been resolved, NFA decided to close its investigation and refer it to the Exchange for review for potential violations relating to Exchange rules 410 (Good Faith Bids and Offers) and 607 (Cooperation in Investigations and Proceedings). In November 2009, NYSE Liffe issued a warning letter to the market participant for the apparent violation of Exchange rule 602 (Fictitious Transactions). The warning letter stated that the reason for the self-trading was that the logic of the market participant's order-routing gateway allowed its orders to pass to the Exchange's Trading Platform and execute against its own resting orders resulting in the market participant trading against itself.³⁶ As a consideration for not referring the matter to an Exchange review panel, the warning letter cited the lack of any evidence that the trading activity was done for any improper purpose and the highly technical nature of the issue.

³⁵ The Division was unable to ascertain when the Exchange actually passed NFA's questions along to the market participant.

³⁶ The Warning Letter issued to the market participant stated that NYSE Liffe concluded the self-trades were the result of the following: "When [the market participant's] aggressing algorithm generates an order and sends it to [the market participant's] order-routing gateway that could execute against an order resting on the NYSE Liffe US Trading Platform placed by [the market participant's trading] algorithm, the order-routing gateway will hold the aggressing order, at least initially, while it attempts to cancel the resting...order by order ID. The order ID is assigned by the NYSE Liffe US Trading Platform. In cases where the order ID has not yet been received back from the Trading Platform, [the market participant's] order-routing gateway only holds the aggressing order for a limited period, and will send the aggressing order without first sending a message to cancel the resting...order. [The market participant's] order-routing gateway, therefore, is programmed to release the aggressing order without necessarily sending a message cancelling the potentially offsetting...order."

The Division is concerned about the manner in which the Exchange dealt with this matter. Specifically, after the Exchange recognized that the market participant was conducting a significant number of trades against itself, and during the entire length of the investigation, the Exchange permitted the market participant to continue using the trading system that was resulting in this trading activity. Equally troubling, the market participant's trades against itself were included in the trading volume statistics used to determine the market participant's payments under the Exchange's incentive program. The Division believes that the market participant should not have been permitted to continue using the trading system at issue nor should it have continued to receive its volume based incentive payments.

The Division notes that, unlike in other investigations it reviewed, in this matter NYSE Liffe was an active participant in the investigation. The Exchange's role included acting as an intermediary between NFA and the market participant, even before NFA completed its investigation report. While the Division believes that NYSE Liffe has a responsibility to oversee NFA's regulatory work and that this can include working in tandem on an investigation, any such work should be carefully coordinated and should not delay NFA's investigatory process.

Recommendations with Respect to Adequacy of Inquiries and Investigations

The Division believes that NFA and NYSE Liffe's inquiry and investigation processes are typically adequate. Most inquiries and investigations are thorough and complete. However, the Division believes that the proper response to situations in which automated trading systems are apparently violating Exchange rules, even inadvertently, is for the Exchange to discontinue such systems' access to the Exchange until the cause of the apparent violation is identified and remedied. Accordingly, **the Division recommends that:**

- **NYSE Liffe require market participants whose automated trading systems or algorithms result in trading patterns that are indicative of apparent violations of Exchange rules to discontinue the use of such systems or algorithms until the cause of the apparent violations is identified and remedied.**

Additionally, the Division also believes that NYSE Liffe should ensure that, in the future, its participation in any investigation does not hinder NFA's investigatory process. Accordingly, **the Division recommends that:**

- **NYSE Liffe ensure that its participation in NFA's investigations of potential Exchange rule violations, including any intermediation of discussions between NFA and Exchange market participants, does not delay NFA's investigatory process.**