

February 19, 2002

James C. Yong, Esq.  
Wildman, Harrold, Allen & Dixon  
325 West Wacker Drive  
Chicago, Illinois 60606-1229

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

Dear Mr. Yong:

By letters and electronic mail dated November 26, 2001 through February 11, 2002, Island Futures Exchange, LLC ("Island" 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 Island as a contract market, pursuant to Sections 5 and 6 of the Act, 7 U.S.C. §§7 and 8.

Concurrent with designation, the Commission has approved, pursuant to Section 5c(c) of the Act, 7 U.S.C. §7a-2(c), Island Rules 101, 201-207, 301, 401-412, 501-504, 601-622, 701-703, 801-803, 901, 1001-1006, 1101-1106, 1201-1216, 1301-1307, 1401-1405, 1501-1505, 1601-1607; and the Island Constitution, Articles I-XII.

The Commission's approval is based upon, among other things, written submissions, explanations and representations provided by the Exchange describing the manner in which the Island System will operate. The Commission's designation is also based upon written submissions, explanations, demonstrations, and representations provided by Island and the National Futures Association ("NFA") concerning how NFA shall assist Island in meeting the Exchange's self-regulatory obligations. Finally, the Commission's designation is also based upon written submissions, explanations, and representations provided by Island and The Options Clearing Corporation ("OCC") concerning how OCC shall assist Island in meeting the Exchange's clearing and self-regulatory obligations.

In approving Island's application, the Commission is not approving either the agreement for clearing services between Island and OCC, or the agreement for compliance and surveillance services between Island and NFA. In this connection, Island 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 of Island's rules.

The Commission reminds the Exchange that the identity of and self-regulatory services provided to the Exchange by third-party providers are considered rules and, therefore, changes to these items should be submitted to the Commission pursuant to Section 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 Section 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.

Sincerely,

Jean A. Webb  
Secretary of the Commission

cc: Christopher R. Concannon, Esq.  
Island Futures Exchange, LLC  
50 Broad Street  
New York, NY 10004

## DCM Designation Form

**To:** The Commission

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

**Subject:** Application of Island Futures Exchange, LLC (“Island” 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 Island as a contract market, and simultaneously approve Island’s proposed bylaws and rules.

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

**Processing Information:**

		<b>Responsible Staff</b>	
Official Receipt Date:		Thomas Leahy	418-5278
Review Period:		Rachel Berdansky	418-5429

**I. Background of the Applicant.**

By submission dated November 26, 2001, Island Futures Exchange, LLC, a Delaware limited liability company, a subsidiary of Island Holdings, LLC (“Island Holdings”), applied to the Commodity Futures Trading Commission (“Commission”) for designation as a contract market for the automated trading of futures contracts.<sup>1</sup> Island Holdings also owns and operates The Island ECN (“Island ECN”). Island ECN is an electronic communications network that is registered with the Securities and Exchange Commission (“SEC”) as a broker-dealer and as an Alternative Trading System. Island contracts would trade on a modified version of the Island ECN electronic trading system. That trading system accepts, disseminates, and matches orders.

---

<sup>1</sup> At the request of Commission staff, Island supplemented its submission via e-mails dated December 19, 2001, February 4, 5, 6, 7, and 11, 2002.

The Exchange anticipates that it would offer trading of futures contracts on some or all of the following products: (i) single securities, (ii) narrow-based securities indices, and (iii) other products as determined in the future. When it is legally allowed, the Exchange may establish markets in options on security futures 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.

Island has contracted with The Options Clearing Corporation ("OCC") to carry out clearing and settlement services for all security futures transactions. Island has contracted with the National Futures Association ("NFA"), 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.

The Commission has not previously approved Island as a contract market. Accordingly, the Exchange has submitted to the Commission a proposed trade-matching algorithm, procedures and rules pertaining to Island 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 as the entity for clearing contracts and NFA as the entity to carry out SRO responsibilities for contracts traded on Island including compliance, surveillance, and dispute resolution services. Island has provided the Commission with clear and sufficient information describing the services that NFA and OCC have committed to provide to it.

As set forth in Sections II and III of this memorandum, Island’s 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 Island as a contract market and simultaneously approve Island Rules 101, 201-207, 301, 401-412, 501-504, 601-622, 701-703, 801-803, 901, 1001-1006, 1101-1106, 1201-1216, 1301-1307, 1401-1405, 1501-1505, 1601-1607 (“Rulebook”), and the Island Constitution, Articles I-XII.

**II. Analysis of the Contract Market Application, Island LLC Operating Agreement, Outsourcing Agreements with NFA and OCC, and Proposed Rules for Compliance with the Act’s Designation Criteria and Core Principles for Contract Markets**

CONTRACT MARKET CRITERIA FOR DESIGNATION	ISLAND PROPOSAL	COMMENTS
<p><b>Sec. 5(a) Applications</b> – “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 November 26, 2001, through February __, 2002.</p>	<p>Acceptable  <i>See Attachments</i></p>
<p><b>Sec. 5(b) CRITERIA FOR DESIGNATION</b></p>		
<p><b>Designation Criterion 1 <i>In General</i></b> – “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>Island’s submissions dated November 26, 2001 through February 10, 2002, that include the Island Contract Market Application, Rulebook, Constitution, Operating Agreement, Island/NFA Regulatory Services Agreement (“RSA”), OCC/Island Clearance and Settlement Agreement, Island Membership Agreement, and Island Member Access Agreement.</p>	<p>Acceptable  <i>See Attachments</i></p>
<p><b>Designation Criterion 2 <i>Prevention of Market Manipulation</i></b> – “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>Island Rule 611 specifically bars price manipulation.  Island has entered into an agreement with NFA to assist it in carrying out various self-regulatory responsibilities with respect to market surveillance. (<i>See Island/NFA RSA</i>)</p>	<p>Acceptable.  NFA has provided similar market surveillance procedures to the Merchants’ Exchange (“ME”), OnExchange and BrokerTec, three markets that have recently been granted designated contract market status by the Commission.  NFA has established procedures designed to reveal violations of various trading abuses, including attempts to manipulate futures prices. Island’s market surveillance staff, located in its New York office, will monitor overall activity in each market on a real-time basis and oversee NFA’s surveillance activities. NFA would provide Island with data regarding positions of large traders, deliverable supplies and futures and cash prices. The market surveillance conducted by NFA is specified in Schedule A of the RSA.</p>

CONTRACT MARKET CRITERIA FOR DESIGNATION	ISLAND PROPOSAL	COMMENTS
<p><b>Designation Criterion 3 Fair and Equitable Trading</b>  – “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 person that violates the rules. The rules may authorize – (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>Island has established trading rules and trading protocols to detect and deter trading abuses.  Rule 201(f)(4) prohibits wash sales, accommodation trades and prearranged trades, except as may be permitted under the Rules.  Rule 402(b) prohibits fraud, manipulation and false statements.  Rule 612 prohibits fictitious transactions.  Rule 613 prohibits circulation of false information or rumors.  Rule 614 indirectly prohibits front-running and trading ahead by requiring customer priority.</p> <p>Island’s Disciplinary rules (to detect, investigate and discipline violations of its rules) are set forth in Chapter 12.</p> <p>Rule 605 authorizes EFPs  Rule 606 authorizes EFSs.  Rule 610 authorizes transfer trades.</p> <p>Rule 603(b) authorizes nondisplayed orders which would be eligible for execution but not on display on the Exchange limit order book.</p> <p>Rule 603(h) authorizes paired orders, provided that the paired order is done at a limit price that is superior to the current best- priced buy and sell orders on the limit book. Such paired orders are not required to be entered into the Exchange limit order book as a result</p>	<p>Acceptable.  Island has entered into an agreement with NFA to assist it in carrying out various self-regulatory responsibilities with respect to market surveillance, trade practice surveillance, disciplinary functions, financial surveillance and arbitration. (<i>See</i> executed Island/NFA RSA.) Additionally, Island compliance personnel would monitor compliance with trading rules through exception reports, audit trails and real-time monitoring of trading.</p> <p>Nondisplayed orders include orders more commonly known as “iceberg orders.” Iceberg orders are generally large orders that display a portion of the order on the limit order book (tip of the iceberg), while the remainder of the order is nondisplayed (hidden underneath), so as not to disrupt the current marketplace by the size of the order. The nondisplayed portion of the order receives no time priority until it becomes displayed on the limit order book, which is generally triggered by execution of the displayed portion of that order.</p> <p>Rule 603(h) (Paired Orders) is consistent with Rule 407 (Best Execution). Rule 407 requires that in any transaction for or with a customer, a Member shall seek the most favorable terms reasonably available under the circumstances for the customer’s transaction.</p>

CONTRACT MARKET CRITERIA FOR DESIGNATION	ISLAND PROPOSAL	COMMENTS
	over such displayed orders on the Exchange limit order book.	<i>See Novel or Unusual issues section below for further discussion of Paired Orders.</i>
<p><b>Designation Criterion 4 Trade Execution Facility</b> – “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>Island’s Contract Market Application; Island’s December 17<sup>th</sup> response to CFTC’s Technical Review questionnaire; Island’s System Architecture Schematic; Island’s Data Requirements for Trading, Clearing, and Reporting; Island’s Data Requirements and System Connectivity Schematic for Surveillance System; Island’s Disaster Recovery Plan; Island’s Quality Management System documentation; Island’s System Security Policies for securing the network, the local administrator account, and the Windows 2000 server environment; SEC’s August 24, 2001 report to Island on the SEC Automation Review Policy (“ARP”) Inspection of March 26-28, 2001; Island’s December 14, 2001 response to the SEC ARP report; Independent Assessment of Island’s InfoCenter Application Architecture; Independent Informed External Penetration Test of Island’s InfoCenter Application</p>	<p>Acceptable</p> <p>Orders would be executed in accordance with a price-time priority algorithm. The highest order to buy (or the lowest order to sell) would have priority over all other orders to buy (or all other orders to sell). Where orders to buy (or to sell) are made at the same price, the order clearly established as the first made at such particular price shall have precedence at that price, up to the number of shares of stock specified in the order to buy (or to sell); provided that an order to buy (or to sell) designated as a nondisplayed order shall not have precedence over any order to buy (or to sell) at the same price submitted to the Exchange limit order book for execution and display. In the event that less than the full size of an order is executed, the unexecuted displayed size of the order shall retain priority at the same limit price in accordance with the above-mentioned requirements.</p> <p>This algorithm is substantially similar to ones previously approved by the Commission for other electronic trading systems.</p> <p>Island has provided extensive documentation regarding their system and its operation. That documentation includes system architecture diagrams and descriptions, security policies and procedures, system development life cycle management plans, quality control policies and procedures, capacity planning guidelines, and disaster recovery plans. Island also provided copies of a technical review conducted by the SEC and an application security</p>



CONTRACT MARKET CRITERIA FOR DESIGNATION	ISLAND PROPOSAL	COMMENTS
		<p>party consultant.</p> <p>During site visits on January 8, 2002, to Island’s primary and backup data centers and operations areas, Commission IT staff were able to observe first-hand the trading system and its supporting infrastructure, the staff and operational control facilities supporting the operation, and the physical security and environmental controls provided by the Island facilities.</p> <p>All technical and operational information obtained by Commission staff supports a conclusion that Island’s proposed electronic trading system will comply with the IOSCO principles for screen-based trading and verified that the system operates in accordance with the rules and specifications provided.</p>
<p><b>Designation Criterion 5 <i>Financial Integrity of Transactions</i></b> – “The board of trade shall establish and enforce rules and procedures for ensuring the 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>Island Rule 202 describes the qualifications for Exchange membership.</p> <p>All Island members must be either a member of the Clearing Organization that is deemed qualified by the Exchange or clear transactions in securities through a member of such Clearing Organization.</p> <p>Additionally OCC’s Rules 301 and 302 require clearing members to have initial net capital of \$1 million and to maintain net capital of not less than \$750,000.</p>	<p>Acceptable.</p> <p>Island has contracted with OCC to clear all security futures transactions effected on or subject to the rules of Island. OCC became registered with the Commission as a DCO on December 10, 2001, and may clear futures and futures options and security futures products.</p>
<p><b>Designation Criterion 6 <i>Disciplinary Procedures</i></b> – “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</p>	<p>Rulebook Chapter 12 (Disciplinary Matters) and Chapter 10 (Suspension by Chairman or President); Chapter 11 (Adverse Action); Contract Market Application, pp. 20-21 (disciplinary procedures); Island/NFA RSA.</p>	<p>Acceptable. Island’s Enforcement Staff, which would include NFA personnel pursuant to the Island/NFA RSA, will investigate and prosecute Island’s disciplinary proceedings.</p>

CONTRACT MARKET CRITERIA FOR DESIGNATION	ISLAND PROPOSAL	COMMENTS
<p>functions, including delegation of the functions to third parties.”</p>		<p>Island’s rules would be consistent with Commission regulations and interpretive guidance regarding core principles.</p> <p>Island’s Enforcement Staff would investigate possible rule violations and present written investigation reports to the Business Conduct Committee (“BCC”), which would authorize the issuance of a notice of charges, based on a finding of probable cause, to commence a disciplinary proceeding. The BCC that hears the charges would include two non-Industry directors, two Members of Island, and the President of Island. Island’s Enforcement Staff, which would include NFA personnel, would fill the prosecutorial function in these proceedings.</p>
<p><b>Designation Criterion 7 <i>Public Access</i></b> – “The board of trade shall provide the public with access to the rules, regulations, and contract specifications of the board of trade.”</p>	<p>Contract Market Application, p. 21 (public access).</p>	<p>Acceptable</p> <p>Island represents that it would post all rules and contract specifications on its web site, and disseminate changes to rules and contract specifications to all exchange members and all members of the public who are on a notification list.</p>
<p><b>Designation Criterion 8 <i>Ability to Obtain Information</i></b> – “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>Rules 201(e) and 702(d); Member Access Agreement ¶10(c); Contract Market Application, pp. 21-22 (ability to obtain information).</p>	<p>Acceptable</p> <p>Members would be required to furnish information to Island upon request pursuant to Rule 201(e). Members are specifically required to furnish books and records to Island pursuant to Rule 702.</p> <p>Island Rule 702(d) authorizes Island to enter into agreements with domestic and foreign self regulatory organizations providing for the exchange of information and other forms of mutual assistance for market surveillance, investigative, enforcement and regulatory purposes. Island represents that it intends</p>

CONTRACT MARKET CRITERIA FOR DESIGNATION	ISLAND PROPOSAL	COMMENTS
		<p>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 Island proposed rules with the Act’s Core Principles for Designation as a Contract Market.

CONTRACT MARKET CORE PRINCIPLES	ISLAND PROPOSAL	COMMENTS
<p><b>Sec. 5c(b) Common Provisions Applicable to Registered Entities</b>  <b>(1) In General</b> – “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.”  <b>(2) Responsibility</b> – “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, post-trade market surveillance, and dispute resolution services will be contracted out to NFA. Real-time market surveillance will be conducted by Island staff. Clearing services will be contracted out to OCC. <i>See</i> Island/NFA RSA and Island/OCC Clearance and Settlement Agreement.</p>	<p>Acceptable</p> <p>Island would remain responsible for compliance with designation criterion and core principles for which relevant functions would be contracted out.</p>
<p><b>SEC. 5c(c) NEW CONTRACTS, NEW RULES, AND RULE AMENDMENTS –</b>  <b>(1) In General</b> – 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).  <b>(2) Prior Approval –</b>  <b>(A) In General</b> – 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>Island Rulebook, Chapters 1-16, and the Island Constitution.</p>	<p>Acceptable</p> <p>Island has requested that the Commission approve its proposed rules, which include its Rulebook, chapters 1-16, and its Constitution. The Divisions of Economic Analysis and Trading and Markets recommend such approval pursuant to Section 5c(c)(2)(A) of the Act, since Island’s Rulebook and Constitution do not violate any provision of the Act or the Commission’s regulations.</p> <p>The letter from the Commission Secretary apprising Island that it has been designated a contract market and that the Commission has approved its rules and Constitution would note that any change in the identity of the third party providing or the self-regulatory services they provide to the Exchange are considered rules, and should be submitted as such, pursuant to section 5c(c) of the Act and Part 40 of the Commission’s regulations.</p>

<p><b>Core Principle 1 <i>In General</i></b> – “To maintain the 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>Submissions dated November 26, 2001, through February 10, 2002, including the Island Contract Market Application, Rulebook, Constitution, Operating Agreement, Member Access Agreement, Membership Application, Island/ NFA RSA, Island/OCC Clearance and Settlement Agreement, and description of the Island Electronic Trading System.</p>	<p>Acceptable</p>
<p><b>Core Principle 2 <i>Compliance with Rules</i></b> – “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>Contract Market Application, pp. 9-10 (Trade Practice Surveillance and Audit Trail); pp. 13-16 (Real-Time and Post-Trade Monitoring of Trading, Audit Trail, and Fair and Equitable Trading); pp. 20-21 (Disciplinary Procedures); pp. 22-23 (Compliance with Rules); and p. 28 (Trade Information). RSA, Schedule A (Scope of Regulatory Services). Rule 201 (Rights, Privileges and Obligations of Members); Rule 402(a) (Compliance with Applicable Laws); Rule 603 (Entry, Display and Execution of Orders); Rules Chapter 10 (Suspension by Chairman or President); Rulebook Chapter 11 (Adverse Action); Rule 1202 (Complaint and Investigation); and Rules 1203-1216 (Disciplinary Procedures).</p>	<p>Acceptable. Island has contracted with NFA to operate its trade practice surveillance and disciplinary programs. NFA performs similar functions for ME and BrokerTec.</p> <p>NFA has established procedures to detect violations and various trading abuses, including the ability to monitor for price manipulations, large trader positions, and deliverables and futures and cash prices.</p> <p>NFA has sufficient staff and resources, including its automated surveillance system and software for monitoring the Internet, to detect and investigate potential rule violations, including abuses specific to the trading of SFPs. In this regard, NFA has established procedures for regularly reviewing exception reports and utilizing user profiles.</p> <p>Island will maintain a full electronic audit trail record of all trades and orders submitted to the Trading System, including orders that do not result in executions. All messaging within the Trading System also will be recorded for audit trail purposes. The Trading System will transfer audit trail information to a secure and safe database. This information will be stored on-line in the database for 30 days and stored off-line in a readily accessed, machine-readable format for seven years.</p> <p>NFA will have real-time access to Island’s supervisory screens and will receive trade data on a T+1 basis.</p>

		Island and NFA have established appropriate procedures to promote the fairness of investigations and ensure appropriate, thorough, and timely investigative analysis. Island and NFA also have established acceptable procedures, clear and fair standards, and reasonable timelines for both summary and non-summary disciplinary actions.
<b>Core Principle 3</b> <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.”	Contract Market Application, p. 24	Acceptable. Island did not submit a futures contract with its Contract Market Application. Island intends to submit contract terms and conditions after it has been designated a contract market.
<b>Core Principle 4</b> <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.”	Contract Market Application, pp. 9-15, and 28, and Island/NFA RSA (provides for monitoring of large trader positions, deliverable supplies, and cash and futures prices).	Acceptable. Island has contracted with NFA to provide specific market surveillance functions. Island will provide the necessary data to NFA to conduct post-market surveillance.  Island will conduct real-time surveillance through trading and event alerts on its Electronic Trading system, NFA will conduct post-trade surveillance using daily data feed at the end of the trading day. The surveillance procedures outlined in the Island Contract Market Application should minimize the potential for manipulation, distortion of prices, or disruption of delivery.
<b>Core Principle 5</b> <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 adopt position limitations or position accountability for speculators, where necessary and appropriate.”	Contract Market Application, pp. 24-25.  Island Rule 615 establishes hedge exemptions and aggregation of positions.	Position limits or accountability limits will be established in the rules and contract specifications of Island futures and options contracts. Those contracts are not included in Island’s Contract Market Application. Island’s rules acknowledge CFTC Regulation 150 regarding the setting of position limits, exemptions from speculative position limits for bona fide hedging positions and other 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

		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><b>Core Principle 6 <i>Emergency Authority</i></b> – “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>Constitution Article IV, Sections 7, 15; Rule 616; Contract Market Application, pp. 25-26.</p>	<p>Acceptable</p> <p>By a two-thirds vote, Island’s Board could place into immediate effect temporary rules pursuant to Article IV, Section 15 of Island’s Constitution. 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 Article IV, Section 7, no Board member could vote if such member had a specified relationship with a named party in interest or a substantial financial interest based upon Island or non-Island positions. The member could participate in deliberations (but not vote) if, after the Board was informed of the conflict, disinterested Board members so decided upon consideration of whether the member’s participation were necessary to achieve a quorum and whether the member has unique or special expertise, knowledge or experience in the matter under consideration.</p> <p>Island could also take various actions in response to physical emergencies, which would include any circumstance that could have a severe or adverse effect upon Island’s physical functions. See Article IV, Section 15(c).</p> <p>In addition, pursuant to Rule 616, the Chairman of the Board of Directors or the President of the exchange may suspend trading in any contract traded on the Exchange if in his or her opinion such a suspension would be in the public interest. No action under this rule would continue longer than a period of two days, unless approved by the Board of Directors.</p>
<p><b>Core Principle 7 <i>Availability of General Information</i></b></p>	<p>See Island Contract Market Application pp. 21, 26.</p>	<p>Acceptable.</p>

<p>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>Island will publish its rules, regulations and contract specifications on its website.</p>
<p><b>Core Principle 8 Daily Publication of Trading Information</b> – “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>Contract Market Application, p. 27.</p>	<p>Acceptable.</p> <p>Daily information on settlement prices, volume, the total quantity of EFP transactions and total open interest would be made public through market data vendors. In addition, Island would disseminate on a continuous basis through market data vendors, the lowest price or offer and the highest price or bid that Island reasonably determines accurately reflect market conditions. Should there be no transactions during the opening or closing periods, Island has procedures in place for determining and disseminating first or last price data or nominal opening or closing prices that Island reasonably believes reflect accurate market conditions. The methods and procedures used by Island to determine settlement and nominal prices will be made publicly available through market vendors.</p>



<p><b>Core Principle 9 Execution of Transactions</b> – “The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions.”</p>	<p>Island’s Contract Market Application; Island’s December 17<sup>th</sup> response to CFTC’s Technical Review questionnaire; Island’s System Architecture Schematic; Island’s Data Requirements for Trading, Clearing, and Reporting; Island’s Data Requirements and System Connectivity Schematic for Surveillance System; Island’s Disaster Recovery Plan; Island’s Quality Management System documentation; Island’s System Security Policies for securing the network, the local administrator account, and the Windows 2000 server environment; SEC’s August 24, 2001 report to Island on the SEC Automation Review Policy (ARP) Inspection of March 26-28, 2001; Island’s December 14, 2001 response to the SEC ARP report; Independent Assessment of Island’s InfoCenter Application Architecture; Independent Informed External Penetration Test of Island’s InfoCenter Application</p>	<p>Acceptable</p> <p>Island has provided sufficient documentation and other information for Commission staff to conclude that the Island system would comply with the IOSCO principles for screen-based trading systems.</p> <p>Island’s Quality Management System, as described in the documentation provided to the Commission, includes a section that thoroughly addresses all areas of testing. Island’s Quality Assurance (QA) group, guides the development of test plans and testing methodology. Test plans are based on system requirements defined during the definition/design phase of the System Development Life Cycle (SDLC). System requirements included in the plan span the areas of function, capacity, reliability, and security, including interfaces to external systems.</p> <p>Island’s system has been the subject of several reviews conducted by qualified independent professionals during the past ten months. The SEC conducted an inspection on March 26-28, 2001. The purpose of that inspection was to determine if Island’s general controls over information technology resources were consistent with the SEC’s Automation Review Policy. Based on their inspection, on August 24, 2001 the SEC made eight recommendations to Island for improvements in several areas, including formal documentation of disaster recovery planning and capacity planning, development and implementation of System Development Management and Quality Assurance policies and procedures, establishment of an internal audit function, and full implementation of existing security policies and procedures. On December 14, 2001, Island’s Chief Operating Officer, John Hillen, submitted a report to the SEC describing Island’s progress in responding to the eight recommendations.</p> <p>On January 24, 2002, Island gave a demonstration of</p>
---	--	--

	<p>Rule 604 describes Island's Block Trading.</p>	<p>Island headquarters in New York. The demonstration included, among other things, execution of displayed and nondisplayed orders, paired orders, immediate or cancel orders, day orders, partially filled orders, cancelled orders and depth of book. The demonstration did not include execution of EFP, EFS or Block Trading transactions, as that capability was not available at the time of the demonstration.</p> <p>The documentation provided by Island indicates, and the demonstration of the Island Trading system verified, that Island provides for open, competitive and efficient trading on the Island trading facility. <i>See Novel or Unusual Issues Section for further description of Paired Orders.</i></p> <p>Block Trading at Island is substantially similar to the Block Trading Rules recently approved at Nasdaq LIFFE. Any member who is an Eligible Contract Participant ("ECP") is permitted to arrange block trades on the Island system. Similarly, when a member enters into a block trade on behalf of a customer, the customer also must be an ECP. Island intends to allow inter-commodity spreads between commodities with different minimum block size thresholds. For such transactions, the lesser of the minimum block size thresholds would apply. The block trade executing member must report the trade to the Exchange within five minutes of agreement on the terms of the block trade. Subsequently, the Exchange will promptly publish the relevant details of the block trade on the Island Trading System.</p> <p>Island has not submitted minimum block transaction size thresholds because no specific futures contracts have been submitted with its Contract Market Application. Island intends to submit contract terms and conditions after it has been designated a contract market.</p>
--	---	--

<p><b>Core Principle 10 Trade Information</b> – “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 the contract market to use the information for 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>Contract Market Application, pp. 6-7 (Access Restrictions); pp. 9-10 p.10 (Trade Practice Surveillance and Audit Trail); p.11 (System Capacity and Security); pp. 13-14 (Real-Time and Post-Trade Monitoring of Trading and Audit Trail); p. 28 (Trade Information). RSA, Schedule A (Scope of Regulatory Services). Rule 603(Entry, Display and Execution of Orders); Rule 619 (Safeguarding Access to Exchange).</p>	<p>Acceptable. Island has contracted with NFA to operate its trade practice surveillance program. NFA has established procedures for the detection and investigation of trading abuses. In this regard, NFA will utilize its automated surveillance system and software to conduct Internet surveillance.</p> <p>Orders submitted to the Trading System must specify buy or sell, total number of contracts to be bought or sold, minimum number of contracts that may be executed as part of the total order; symbol of the SFP to be bought or sold, time in force, Market Participant Identifier for Member entering order, CTI code, and the portion of the order to be displayed. The Trading System will reject orders not containing required information. Bunched orders must carry a Series Designation.</p> <p>Any order, except a proprietary order, which is not in the form of an electronic or written record and which is not immediately entered into the Trading System upon receipt, must immediately upon its receipt, be recorded in writing or caused to be recorded in writing by the Member or its employee receiving such order.</p> <p>Island’s 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 second. All activity and messaging within the Trading System will be recorded in the Trading System database in a secure and complete record that Members cannot 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. Island’s security measures will be implemented through physical and electronic barriers to Trading System hardware.</p> <p>NFA’s automated surveillance system will enable NFA to reconstruct Island transactions and to create</p>
---	---	---

		Island’s supervisory screens and will receive data on a T+1 basis.
<p><b>Core Principle 11 <i>Financial Integrity of Contracts</i></b> – “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>Chapter 2 of Island’s Rulebook sets forth financial integrity standards for members.</p> <p>Chapter 3 of OCC’s Rules sets forth minimum financial rules for all clearing members.</p>	<p>Acceptable</p> <p>Island is contracting with OCC to clear all security futures transactions effected on or subject to the rules of Island. OCC became registered with the Commission as a DCO on December 10, 2001 and may clear futures and futures options and security futures products.</p> <p>Island has entered into an agreement with NFA for NFA to assist Island in carrying out, among other things, financial surveillance over those members for which Island is the DSRO. Other Island members will be subject to financial surveillance by their particular DSROs. NFA will perform those auditing and financial surveillance functions described in CFTC Guideline 4-1, 4-2 and other applicable CFTC regulations and interpretations. This will include performing audits of users for which Island is the DSRO, reviewing periodic financial statements submitted by such firms and daily monitoring of customer funds held in segregation. Island states that NFA has agreed to work with Island to amend NFA’s audit programs in any way necessary to ensure appropriate testing for any Island requirements not already covered in the existing programs.</p>
<p><b>Core Principle 12 <i>Protection of Market Participants</i></b> – “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>Island Rule 407 requires a member to seek the most favorable terms reasonably available under the circumstances for the customer’s transaction.</p> <p>Island Rule 603(j) requires a member receiving an order from another Person to be entered into the Island Trading System immediately upon receipt or as soon thereafter as practicable and in the sequence received.</p> <p>Rule 201(f) details prohibited conduct (<i>i.e.</i>, providing</p>	<p>Acceptable.</p> <p>Island has contracted with NFA to assist in carrying out self-regulatory responsibilities with respect to trade practice surveillance. Island will provide data to NFA in order for NFA to monitor trading practices on Island. The NFA’s current trade practice programs include creating exception reports to identify trading ahead of customers, direct crossing, prearranged trading, wash trading, money passing, counterparty trade percentages, stop order fishing,</p>

	<p>sale, accommodation trade or prearranged trade, violating the Act, Commission Regulations, or Exchange Constitution, rules or procedures or Clearing Organization bylaws, rules or procedures).</p> <p>Rule 612 prohibits fictitious transactions. Rule 613 prohibits circulation of false information or rumors.</p>	<p>activity and off exchange transactions. (See Island/NFA RSA, Appendix A for a detailed description of NFA’s trade practice surveillance program.)</p>
<p><b>Core Principle 13</b> <i>Dispute Resolution</i> – “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.”</p>	<p>Chapter 13 of Island’s Rules regarding Arbitration; Island/NFA RSA</p>	<p>Acceptable. Island has contracted with NFA to provide arbitration services.</p> <p>The proposed dispute resolution facility is voluntary for non-ECP customers. See Rule 1305. Pre-dispute arbitration agreements between Island’s members and non-ECP customers will conform to Commission Regulation 166.5. See Rule 1307.</p>
<p><b>Core Principle 14</b> <i>Governance Fitness Standards</i> – “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).”</p>	<p>Constitution, Article IV, Section 13; Rules 202(b), 204(a), 206 and 207.</p>	<p>Acceptable</p> <p>To become an Island member, a natural person must be old enough to enter into contracts and be either a registered futures commission merchant and broker-dealer, or associated with a registered futures commission merchant and broker-dealer. A non-natural person must be either a registered futures commission merchant and broker-dealer, or a Qualified Eligible Person as defined in CFTC rule 4.7. An applicant may not be subject to a statutory disqualification under either section 8a(2) or 8a(3) of the Act, or section 3(a)(39) of the Exchange Act. Among other things, an applicant must also be financially suitable, be in good commercial standing and have reasonably adequate systems capability and capacity for the type and level of activity the applicant will have on the exchange. Members must continue to meet the requirements for membership and file reports with Island disclosing events that</p>

		<p>disciplinary actions by governmental or self-regulatory entities.</p> <p>Island Board and Committee members must meet the standards set forth in CFTC rule 1.63.</p>
<p><b>Core Principle 15</b> <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>Constitution, Article IV, Sections 7 and 14; Article VI, Section 10.</p>	<p>Acceptable.</p> <p>Island prohibits any Board member or member of a Committee appointed by the Board from knowingly participating in the deliberation or vote on a matter if the member is the named-party in interest, has a specified relationship with a named-party in interest, or has a substantial financial interest in the matter. Island requires those members to disclose any such conflicts of interests. A member may participate in the deliberation of a matter in which the member has a substantial financial interest if the member’s presence is necessary for a quorum or the member possesses unique expertise. No such member may inappropriately use or disclose non-public information obtained during the member’s participation on the Board or a Committee.</p> <p>An Island employee may not trade any commodity interest regarding which the employee has access to material non-public information. Island’s President may make some exceptions to that rule such as for trading in a pooled investment account over the trading of which the employee has no control.</p>
<p><b>Core Principle 16</b> <i>Composition of Boards of Mutually Owned Contract Markets</i> – “In the case of a mutually owned contract market, the board of trade shall ensure that the composition of the governing board reflects market participants.”</p>	<p>Constitution, Article IV, Section 3; Contract Market Application, p. 31.</p>	<p>Acceptable.</p> <p>Membership in Island will not represent an ownership interest in the Exchange. The Exchange will be owned by “LLC Members.” Initially, there will be only one LLC Member, Island Holdings LLC, which may expand the LLC membership. Article IV,</p>

		Island’s Board of Directors shall be composed of the CEO, President, and 13 directors, seven of whom will be non-industry directors and at least two of whom shall be public directors (directors who have no material business relationship with a broker-dealer or Commission registrant), and the remaining six directors shall be industry directors.
<b>Core Principle 17 Recordkeeping</b> – “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.”	Rule 701 requires that Members report information in such manner and form and at such times as may be prescribed by the CFTC.	Acceptable.  The Island application states that each Member is required to retain such information for a period of five years from the date thereof, and to make such records readily accessible to inspection by any representative of Island, the Department of Justice, the CFTC or any other regulatory or self-regulatory organization which has jurisdiction over the Member and Island for the first two years of the five year period. (Contract Market Application, pp. 22-23)  The Island Trading System 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 second. All activity and messaging within the Trading System will be recorded in the Trading System database in a secure and complete record. These data will be maintained on-line for 30 days, and stored off-line in a readily-accessible, machine-readable format for seven years and can be readily accessed.
<b>Core Principle 18 Antitrust Considerations</b> – “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.”	Application, p. 32; Island Regulatory Chart	Acceptable  The Exchange has represented that Island membership will be widely accessible and will operate through an electronic auction market that is open and competitive. The Exchange has expressed its belief that its governing rules and constitution comply with this core principle.

		Island's Contract Market Application, Rulebook, Constitution, Operating Agreement, Island/NFA RSA, or the Island/OCC Settlement and Clearance Agreement.
--	--	--





## U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre  
1155 21st Street, NW, Washington, DC 20581  
Telephone: (202) 418-5000  
Facsimile: (202) 418-5521

### IV. Novel or Unusual Issues

#### *Paired Orders*

Orders to buy or sell contracts submitted to Island are generally displayed on the Island limit order book. Island intends, however, to allow for the execution of “paired orders” that would not be displayed on the Island limit order book in certain instances.

A paired order is essentially a cross trade. An Island member holding executable buy and sell orders may match those orders against each other without displaying the orders on the Island limit order book. While the CEA would not prohibit a paired order, a board of trade is required to provide a competitive, open and efficient market and mechanism for executing transactions (core principle 9). Paired orders would satisfy core principle 9’s requirements for open and competitive execution because Rule 603(h) would be limited to orders that are executed at a limit price that is superior to the current best priced buy and sell orders on the limit order book. Furthermore, the Exchange would assure that the paired order price complies with the superior price requirement by checking the paired order price before the trade is deemed to be effected by the Exchange.

Traditionally, securities exchanges and ECNs have been held to a “best execution” standard for executing transactions. At the January 24, 2002 Island Trading System demonstration, Island indicated that best execution historically equated to “best price.” As the markets have evolved, best execution can require more than just the best price for the customer. Best execution may require best price plus liquidity or best price plus size, depending on the nature of the customer. In Island’s case, best execution would be accomplished in certain

instances by allowing paired order execution. Since paired orders would not be not displayed on the Island limit order book or matched by the Island trade matching engine, transaction costs would be lower for the member and the customer, resulting in a more efficient market.

As a paired order at Island only could be transacted when the price of the paired order would be an improvement upon the current bid/ask price in the marketplace, Commission staff has concluded that Rule 603(h) would satisfy core principle 9's requirement of open, competitive and efficient execution.

**V. Attachments**

- A. November 26, 2001 Application Letter from Island to the Commission
- B. Island Contract Market Application
- C. Island Rulebook
- D. Island Constitution
- E. Island Operating Agreement
- F. Island Membership Application
- G. Island Member Access Agreement
- H. Island/NFA Regulatory Services Agreement
- I. Island/OCC Settlement and Clearance Agreement