

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 51524 / April 12, 2005

ADMINISTRATIVE PROCEEDING
File No. 3-11892

In the Matter of

New York Stock Exchange, Inc.,

Respondent.

**ORDER INSTITUTING PUBLIC
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTIONS 19(h)(1) AND
21C OF THE SECURITIES EXCHANGE
ACT OF 1934, MAKING FINDINGS,
ORDERING COMPLIANCE WITH
UNDERTAKINGS, AND IMPOSING A
CENSURE AND A CEASE-AND-DESIST
ORDER**

I.

The Securities and Exchange Commission (“Commission”) deems it necessary and appropriate in the public interest and for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Sections 19(h) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”) against the New York Stock Exchange, Inc. (“NYSE”).

II.

In anticipation of the institution of these proceedings, the NYSE has submitted an Offer of Settlement (the “Offer”) that the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission or in which the Commission is a party, and without admitting or denying the findings contained herein, except as to the Commission’s jurisdiction over the NYSE and the subject matter of these proceedings, the NYSE consents to the entry of this Order Instituting Public Administrative Proceedings Pursuant to Sections 19(h)(1) and 21C of the Securities Exchange Act of 1934, Making Findings, Ordering Compliance with Undertakings, and Imposing a Censure and a Cease-And-Desist Order (the “Order”), as set forth below.

III.

On the basis of this Order and the Offer submitted by the NYSE, the Commission finds¹ that:

A. RESPONDENT

1. The NYSE is a New York not-for-profit corporation that is, and at all times relevant hereto was, registered with the Commission as a national securities exchange pursuant to Section 6 of the Exchange Act. The NYSE first registered as a national securities exchange with the Commission on October 1, 1934. In 2003, the NYSE had a total of 2,750 listed companies trading on its market with a global market capitalization of \$17.3 trillion. The total share volume traded on the NYSE in 2003 was 352.4 billion shares, and the average daily share volume was 1.4 billion shares valued at \$38.5 billion. For the year ending December 31, 2003, the NYSE reported total revenues of nearly \$1.1 billion and net income of \$49.6 million.

B. FACTS

Summary

2. This matter concerns the failure of the NYSE to properly detect, investigate, and discipline widespread unlawful proprietary trading by specialists on the floor of the NYSE. Section 19(g)(1) of the Exchange Act obligates the NYSE, as a self-regulatory organization (“SRO”), to comply, and enforce compliance by its members, with the Exchange Act, the rules and regulations thereunder, and the rules of the NYSE. In carrying out its duty to “enforce compliance,” SROs must develop and maintain surveillance over its members, and “be vigilant in surveilling for, evaluating, and effectively addressing issues that could involve violations” of the securities laws. *National Ass’n of Sec. Dealers, Inc.*, 62 S.E.C. Docket 1346, Release No. 34-37538, 1996 WL 447193, at *2 (Aug. 8, 1996).

3. From 1999 through 2003, various NYSE specialists repeatedly engaged in unlawful “interpositioning” and “trading ahead” of customer orders resulting in more than \$158 million of customer harm. From 1999 through almost all of 2002, the NYSE failed to adequately monitor and police specialist trading activity, allowing the vast majority of this unlawful conduct to continue undetected. The NYSE knew or, in view of all the facts and circumstances, should have known that specialists were repeatedly engaging in interpositioning and trading ahead conduct. The NYSE’s regulatory response to the improper proprietary trading was materially deficient for the following reasons: (a) the NYSE’s surveillance system for detecting trading ahead and interpositioning was unreasonable in that it included parameters and procedures that captured only a small portion of the misconduct; (b) the NYSE failed to conduct adequate investigations

¹ The findings herein are made pursuant to the NYSE’s Offer and are not binding on any other person or entity in this or any other proceeding.

of the trading ahead and interpositioning violations that it did find; and (c) the NYSE failed to adequately discipline specialists who were found to have engaged in unlawful trading. In so doing, the NYSE violated Section 19(g) of the Exchange Act by failing, without reasonable justification or excuse, to enforce Section 11(b) of the Exchange Act, Rule 11b-1 thereunder, and various NYSE Rules, including NYSE Rules 92 and 104.10 which prohibit trading ahead of customer orders.

Prior Commission Action Against the NYSE

4. The NYSE's failure to police trading ahead and interpositioning by specialists follows a regulatory failure by the NYSE in the late 1990s involving independent floor brokers, which was addressed by the Commission in an order against the NYSE in June 1999 (the "1999 Order"). In the 1999 Order, the Commission found that the NYSE had failed to detect and halt unlawful proprietary trading by certain independent floor brokers, who shared in the profits and losses of customer accounts. *See In the Matter of New York Stock Exchange, Inc.*, Admin. Proc. File 3-9925 (Securities Exchange Act Release No. 41574 (June 29, 1999)). As part of those illegal schemes, the NYSE floor brokers used information gained from their position on the trading floor to reap illegal profits from improper proprietary trading, including "frontrunning" of customer orders. In the 1999 Order, the Commission ordered the NYSE to comply with a series of undertakings that were intended to improve the NYSE's regulation of all NYSE floor members, including specialists. For example, the NYSE was ordered to comply with an undertaking that within twelve months of the issuance of the 1999 Order, the NYSE would "enhance and improve its regulation" of all NYSE floor members, including specialists, by, among other things, "ongoing, continuous surveillance" of floor members, including specialists, and "thoroughly investigating indications of possible violations" by floor members, including specialists.

5. The NYSE implemented some enhancements to its specialist surveillance program in response to the 1999 Order. However, the NYSE failed to take sufficient steps to enhance and improve its regulation of specialists, by, among other things, failing to thoroughly investigate indications of possible violations by specialists.

Overview of Specialists' Obligations

6. In the NYSE's continuous two-way agency auction market, specialist firms are responsible for the quality of the markets in the securities in which individual specialists are registered. A specialist is expected to maintain, insofar as reasonably practicable, a "fair" and "orderly" market. Specialists have two primary duties in maintaining a fair and orderly market: performing their "negative obligation" to execute customer orders at the most advantageous price with minimal dealer intervention, and fulfilling their "affirmative obligation" to offset imbalances in supply and demand. Specialists participate as both broker (or agent), absenting themselves from the market to pair executable customer orders against each other, and as dealer (or principal), trading for the specialists' dealer or proprietary accounts when needed to facilitate

price continuity and fill customer orders when there are no available contra parties to those orders.

7. Whether acting as brokers or dealers, specialists are required to hold the public's interests above their own and, as such, are prohibited from trading for their dealers' accounts ahead of pre-existing customer buy or sell orders that are executable against each other. When matchable customer buy and sell orders arrive at specialists' trading posts – generally either through the NYSE's Super Designated Order Turnaround System ("DOT")² to an electronic display book (the "Display Book"),³ or by floor brokers gathered in front of the specialists' trading posts – specialists are required to act as agent, and cross or pair off those orders and to abstain from participating as principal or dealer.

8. The specialists' obligations are embodied in the federal securities laws and NYSE rules, which prohibit trading ahead and interpositioning. Section 11(b) of the Exchange Act and Rule 11b-1 thereunder limit a specialist's dealer transactions to those "reasonably necessary to permit him to maintain a fair and orderly market."⁴ NYSE Rule 92 provides that "no member or member organization shall cause the entry of an order to buy (sell) any Exchange-listed security for any account in which such member or member organization . . . is directly or indirectly interested (a 'proprietary order'), if the person responsible for the entry of such order has knowledge of any particular unexecuted customer's order to buy (sell) such security which could be executed at the same price." NYSE Rule 104.10 states in relevant part: "No specialist shall effect . . . purchases or sales of any security in which such specialist is registered . . . unless such dealings are reasonably necessary to permit such specialist to maintain a fair and orderly market."

2 The DOT system is the NYSE's primary order processing system, supporting equity trading on the trading floor and providing the NYSE with the current status of any equity order. Customers can transmit orders through NYSE member organizations electronically to the floor through the DOT system.

3 The Display Book is an electronic workstation provided by the NYSE to the firm for use by its specialists at their post panels, operated by means of a customized keyboard containing function, letter, number and arrow keys. The Display Book allows specialists to, among other things, receive and process orders, disseminate trade and quote information, report trade executions, research order and execution status, manage positions and view profit and loss in the dealer account.

4 Where specialists effect trades for their accounts that are not "reasonably necessary to permit [such specialists] to maintain a fair and orderly market," they have violated Section 11(b) and Rule 11b-1 of the Exchange Act. See *In the Matter of Weiskopf, Silver & Co.*, 1980 WL 22091, SEC Release No. 34-17361 (Dec. 10, 1980); *In the Matter of Albert Fried & Co. and Albert Fried, Jr.*, 1978 WL 196046, S.E.C. Release No. 34-15293 (Nov. 3, 1978).

The NYSE's Obligation to Regulate the Conduct of Specialists

9. Section 6(b) of the Exchange Act requires the NYSE, as a national securities exchange, to have the capacity to be able to carry out the purposes of the Exchange Act and to comply, and to enforce compliance by its members, with the rules and regulations of the Exchange Act and the NYSE's own rules. Rule 11b-1 under the Exchange Act sets forth the specific rules that a national securities exchange must have if it registers its members to act as specialists. Sections 19(g) and 19(h) of the Exchange Act further require the NYSE, as a self-regulatory organization, to comply with, and enforce the provisions of, the Exchange Act, the rules and regulations thereunder and its own rules. The NYSE has an affirmative obligation to be vigilant in surveilling for, evaluating, and effectively addressing activity that could involve violations of these provisions.

10. The NYSE's Regulatory Group has the responsibility to enforce compliance by its members with the Exchange Act, the rules and regulations thereunder, and the NYSE's own rules. During the relevant time period, the Regulatory Group was comprised of three divisions: (1) Market Surveillance; (2) Member Firm Regulation; and (3) the Enforcement Division. Market Surveillance had the principal responsibility to surveil and investigate specialists for trading violations. Specialist Surveillance, a unit of Member Trading II, a department of Market Surveillance, was primarily responsible for conducting surveillance of specialists' trading. Analysts within Specialist Surveillance reviewed "alerts" from automated surveillances and referred potential violations to Trading Investigations, which during the relevant time period was also organized within the Member Trading II department of Market Surveillance. Trading Investigations was responsible for conducting in-depth investigations of potential rule violations referred by, among others, Specialist Surveillance. Market Surveillance, based on the results of the investigation, could impose informal discipline, primarily letters of admonition or summary fines, but serious rule violations had to be referred to the NYSE's Enforcement Division with a recommendation for formal disciplinary action.

The NYSE's Failure to Enforce Statutes and Rules Governing Trading by Specialists

The Specialists' Unlawful Trading Ahead and Interpositioning

11. During the period January 1999 through 2003, various NYSE specialists repeatedly violated their duty to refrain from dealing for their own accounts while in possession of buy and sell customer orders executable against each other. They did this primarily in two ways: (i) by "interpositioning" – *i.e.*, effecting two improper proprietary trades close in time by filling *both* opposing orders from the proprietary account at prices that enable the specialist firm to profit from the spread between both prices; and (ii) by "trading ahead" – *i.e.* filling one executable order out of the firm's own account instead of matching it with another executable public order – and then by filling the second executable public order through an agency trade at a less advantageous price.

12. The unlawful proprietary trading by NYSE specialists was widespread and pervasive, involving all seven equity specialist firms operating on the NYSE. In March and July 2004, the Commission and the NYSE instituted settled administrative proceedings against all seven firms. The Commission and the NYSE found that, between 1999 and 2003, these specialist firms (i) willfully violated Section 11(b) of the Exchange Act and Rule 11b-1 thereunder; (ii) violated various NYSE rules, including NYSE Rules 92 and 104.10; and (iii) failed adequately to supervise certain specialists, who themselves engaged in fraud through proprietary trading in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.⁵ The Commission and the NYSE further found that unlawful proprietary trading at the seven specialist firms caused in the aggregate more than \$158 million in customer harm. Pursuant to the settlements between the specialist firms, the Commission and the NYSE, the specialist firms agreed to disgorge this amount and were penalized a total of \$90 million.

The NYSE Failed to Adequately Surveil for Trading Ahead and Interpositioning Violations

13. From 1999 through almost all of 2002, the NYSE's surveillance systems failed to detect the vast majority of trading ahead and interpositioning by specialists. This failure was in part due to the NYSE's reliance on an automated surveillance system whose parameters and procedures were unnecessarily and unreasonably broad. The DOT Inferior Price Execution Surveillance ("DOT Surveillance") had been implemented by the NYSE in the late 1980s to detect trading ahead by specialists. When specialists engaged in trading that exceeded certain parameters of the DOT Surveillance, alerts were generated identifying potential trading ahead activity. The most significant parameters of the DOT Surveillance were the time and spread parameters.

14. Although every instance of trading ahead and interpositioning constitutes a violation, the DOT Surveillance only generated an alert if the specialist traded ahead of an agency DOT order that had been visible on the Display Book for a certain period of time. From 1999 through 2002, the time parameter was reduced from 90 seconds to 60 seconds, but was consistently set beyond a level that could be reasonably justified. As a result of using unnecessarily long time parameters, the DOT Surveillance failed to detect the vast majority of trading ahead and interpositioning violations.

⁵ See *In the Matter of Bear Wagner Specialists LLC*, Rel. No. 34-49498 (March 30, 2004); *In the Matter of Fleet Specialist, Inc.*, Rel. No. 34-49499 (March 30, 2004); *In the Matter of LaBranche & Co. LLC*, Rel. No. 34-49500 (March 30, 2004); *In the Matter of Spear, Leeds & Kellogg Specialists LLC*, Rel. No. 34-49501 (March 30, 2004); *In the Matter of Van der Moolen Specialists USA, LLC*, Rel. No. 34-49502 (March 30, 2004); *In the Matter of SIG Specialists, Inc.*, Rel. No. 34-50076 (July 26, 2004); *In the Matter of Performance Specialist Group LLC*, Rel. No. 34-50075 (July 26, 2004).

15. Similarly, the DOT Surveillance only generated an alert if there was a certain price spread in the specialist's quote (bid and ask) at the time the specialist traded ahead of the customer agency order. Historically, the spread parameter was set at the minimum price variation for trades in a security. In the late 1990s, when the minimum trading increment was a 1/16th of a dollar (\$.0625), the spread parameter was \$.0625. However, the \$.0625 spread parameter remained in place until June 2002, nearly one and a half years after decimalization of stock quotes, which reduced the minimum price variation to one cent. In June 2002, the NYSE lowered the spread parameter slightly to five cents. There is no reasonable justification for a spread parameter beyond the minimum price increment. Because the DOT Surveillance did not capture violations involving small monetary amounts, the specialists were able to trade in small increments and evade detection.

16. Over the years, the NYSE's internal audit group, Regulatory Quality Review ("RQR"), and others advised Market Surveillance on several occasions that the parameters of the DOT Surveillance were unnecessarily broad and recommended reducing the parameters. For example, in 1999 when the time parameter was 90 seconds, RQR issued a report that concluded: "Not to surveil specialists for 90 seconds increases the likelihood that a specialist taking advantage of his dealer and agency capacities for self-interest would remain undetected by Market Surveillance." Similarly, in 2001 and 2002, sample tests were performed by an employee in Market Surveillance's Automation Data Group using a narrower spread parameter, revealing a significant increase in the number of alerts generated. Despite repeated indications that the parameters were too broad, the NYSE made only incremental changes to the DOT Surveillance. The NYSE knew or should have known that these incremental changes were inadequate to gauge the full extent of the trading ahead activity.

17. In addition, the NYSE incorporated an unreasonably narrow review period for the DOT Surveillance. From at least 1996 until June 2002, Specialist Surveillance analysts generally reviewed alerts for each specialist firm for a single day chosen at random each month.⁶ As early as 1996, RQR recommended expanding the review period to one week in order for analysts to better surveil for trading ahead. RQR proposed that the DOT Surveillance generate alerts for an entire week before the analyst selected which day to review. RQR observed that Specialist Surveillance had, on a number of occasions, failed to conduct any review for trading ahead and interpositioning because no alerts were generated for the single day that was randomly selected for review. Despite the fact that Market Surveillance agreed in 1996 to adopt this change, Market Surveillance did not implement a one-week review period until June 2002.

⁶ Analysts were generally only required to review a maximum of three alerts for three different stocks. The three stocks were selected pursuant to a specified selection process. If any of these alerts for these three stocks were found to reflect potential violations, the review would be expanded to alerts in the same stock[s] generated for other days in the same week. In 1999, the procedure was changed to require an expanded review of alerts for the same post-panel generated for the rest of the week.

18. The NYSE did not establish an automated surveillance system specifically designed to detect interpositioning misconduct until late 2002. Although the DOT Surveillance was intended to capture trading ahead violations, the surveillance did not automatically detect interpositioning violations. Rather, Market Surveillance staff used a manual process of reviewing trade data for interpositioning. The NYSE knew that interpositioning was an egregious form of trading ahead and considered this type of conduct a serious regulatory concern. The 1998 and 1999 versions of the Specialist Surveillance procedures manual instructed Specialist Surveillance analysts to “be especially aware of situations where the specialist, after buying/selling the stock, turns around and sells/buys stock against the system order at a profit.” However, the 2000 version of the Specialist Surveillance procedures manual, drafted after the 1999 Order, de-emphasized the detection of interpositioning by merely instructing analysts to “also review[] inferior price execution situations for specialist arbitrage.” Despite knowledge of interpositioning violations, the NYSE did not begin to develop a surveillance system specifically designed to capture interpositioning until mid-2002 and did not fully implement such a system until late 2002.

The NYSE Failed to Adequately Investigate Trading Ahead And Interpositioning Violations

19. Even though the surveillance parameters were unnecessarily broad, they still generated numerous alerts that put the NYSE on notice that trading ahead and interpositioning was widespread. From 1999 through 2002, the DOT Surveillance generated close to 4,000 alerts.⁷ Nonetheless, because of inadequate sampling and selection procedures, the NYSE only reviewed a portion of the alerts generated, and because of inadequate referral procedures (requiring a pattern of likely violations), Specialist Surveillance only referred a smaller fraction of the alerts – approximately 200 – for further investigation. For example, in April 1999, hundreds of alerts were generated for two specialist firms. At one specialist firm, there were over 100 alerts, with 12 alerts in a single specialist’s post and panel and multiple alerts in 19 different stocks. Also in April 1999, at another specialist firm, there were almost 200 alerts, including over 40 alerts in a single stock and 10 or more alerts in two other stocks. Yet, the surveillance analysts failed to refer any of these alerts for further investigation. When alerts were referred for further investigation, pursuant to Market Surveillance procedures, Specialist Surveillance only reviewed and referred a small portion of the total alerts generated. For example, at one specialist firm, there were at least 140 alerts in a seven month time period in 2000; yet, Specialist Surveillance referred only 28 of these alerts, failing to refer multiple alerts in several stocks.

20. Some of the failures by the NYSE’s Specialist Surveillance unit included: (1) Specialist Surveillance regularly overlooked likely instances of trading ahead and interpositioning, even when the specialist firms under review had recently been informally disciplined; (2) due primarily to inadequate referral procedures, Specialist Surveillance failed to

⁷ According to Specialist Surveillance management and analysts, approximately 75% of the alerts they reviewed were likely trading ahead violations.

refer the full extent of trading ahead and interpositioning conduct to Trading Investigations; (3) despite procedures that called for regular and routine surveillance of specialist firms, Specialist Surveillance in at least two instances suspended DOT Surveillance reviews of specialist firms for a period of time after disciplinary action was imposed;⁸ and (4) although Rule 92 explicitly prohibits trading ahead conduct, Specialist Surveillance almost always referred likely trading ahead and interpositioning violations to Trading Investigations under Rule 104.10. Rule 92 violations (which generally require proof of intent) would generally have necessitated a referral to Enforcement for formal disciplinary action; by contrast, Rule 104.10 violations (which do not require proof of intent) could be sanctioned informally by Market Surveillance.

21. Trading Investigations failed to adequately investigate trading ahead and interpositioning misconduct. Trading Investigations had the responsibility to properly investigate trading ahead and interpositioning violations, which included determining (1) the extent of such conduct; (2) whether specialists were engaging in repeated instances of misconduct; (3) whether the misconduct was intentional; and (4) whether the conduct should be referred to the Enforcement Division with a recommendation for formal disciplinary action.

22. Trading Investigations, however, failed in these responsibilities in a number of ways. Investigators did not conduct a thorough investigation of the trading ahead and interpositioning instances that were referred to them. Trading Investigations merely confirmed the specific instances of trading ahead and interpositioning that Specialist Surveillance had referred and did not investigate whether the specialists or specialist firms involved had engaged in additional trading ahead or interpositioning. Investigators believed it was Specialist Surveillance that was responsible for determining the extent of the misconduct.⁹ Furthermore, investigators did not examine or probe the specialists' intent. Other than soliciting an explanation from the firm, which always stated that the trading ahead was accidental, Trading Investigations did not undertake any effort to determine whether the trading ahead was in fact intentional. For example, in an investigation of 28 instances of trading ahead at one specialist firm in 2001, the firm responded in writing that most of the instances were "inadvertent clerical error." As a result, the investigators concluded that "the[se] occurrences appear to be more operational in nature." The investigators did not interview the specialist or his clerk, but simply

8 For example, in January 1999, the DOT Surveillance generated approximately 10 alerts in a single stock for one trade date. Because the specialist firm for this stock had already been disciplined for earlier conduct, Specialist Surveillance decided not to review these 10 alerts.

9 Investigators often lacked basic knowledge of the DOT Surveillance and the selection procedures that Specialist Surveillance used for its referrals. Some investigators erroneously believed that Specialist Surveillance reviewed all alerts generated and referred all alerts that were not false positives. Investigators also did not know how the Display Book operated. This lack of knowledge significantly impaired the investigators' ability to fully investigate instances of trading ahead and interpositioning.

relied on the firm's written response in determining to impose only informal discipline.¹⁰ Finally, Trading Investigations usually did not expand its reviews of trading ahead to other time periods. In the limited instances that Trading Investigations expanded its reviews, the expansion was cursory in nature and lacked adequate review.¹¹

23. Moreover, Market Surveillance failed to pursue what it considered *de minimis* violations, *i.e.* violations that only caused a small amount of customer harm or only resulted in a small amount of specialist gain. For example, in September 1999, Member Firm Regulation referred a single instance of possible interpositioning to Trading Investigations, which did not review the conduct further because it concluded that the customer disadvantage resulting from this single trade (\$37) was *de minimis*. In these types of situations, Market Surveillance wrongly assumed that specialists would not knowingly engage in unlawful conduct for a small amount of pecuniary gain. In fact, various specialists repeatedly engaged in small scale unlawful transactions that in the aggregate added up to tens of millions of dollars.

24. In addition to Specialist Surveillance and Trading Investigations, other units at the NYSE, specifically Member Firm Regulation, which conducts annual and "for cause" examinations of NYSE members, and the Trading Correspondence unit, which handles complaints from member firms and the public, also detected trading ahead conduct during the period 1999 through 2002. Member Firm Regulation referred several trading ahead violations it detected to Market Surveillance under Rule 92 and expected that Trading Investigations would conduct a full investigation of the violative conduct. Trading Investigations, however, during the relevant time period, failed to fully investigate the referred conduct and considered only whether the referred conduct violated Rule 104.10. For example, in August 2001, an examination of one specialist firm by Member Firm Regulation uncovered a significant amount of trading ahead by a single specialist: 94 instances of trading ahead in one stock on a single day, and 44 instances of trading ahead in another stock in a 1½ hour period on that same day. Member Firm Regulation referred the conduct to Trading Investigations in November 2001; yet, Trading Investigations

10 Trading ahead and interpositioning require several deliberate steps executed on the Display Book by the specialist or his clerk that demonstrate a specialist's intent. The Display Book highlights in yellow marketable customer orders. To fill a customer order with a specialist's dealer trade, the specialist or his clerk must take the Display Book out of its "default mode" and input several other keyboard commands. Pairing off two customer orders requires only two keystrokes, whereas trading ahead and interpositioning conduct requires several extra keystrokes. The investigative files do not reflect any attempt to reconcile specialists' repeated claims that multiple instances of trading ahead and interpositioning were "inadvertent" with the fact that such conduct required the specialists to undertake several deliberate steps.

11 For example, in an investigation of 7 instances of trading ahead and interpositioning at one specialist firm in 2002, Trading Investigations noted that in reaching its decision to impose informal discipline, it had conducted an "expanded" review comprised of additional trade dates during 5 different calendar months and determined that there were no additional violations. In fact, the expanded review yielded several additional trading ahead alerts in the stocks surveyed.

failed to take timely action to investigate this conduct. The Trading Correspondence unit also received customer complaints involving trading ahead misconduct, which in some cases involved significant monetary disadvantage to the customer.¹² The Trading Correspondence unit generally took no disciplinary action so long as the specialist firm agreed to pay back the disadvantaged customer.

The NYSE Failed to Appropriately Discipline Trading Ahead and Interpositioning Violations

25. Trading Investigations failed to recommend appropriate discipline of specialists for trading ahead and interpositioning. Throughout the relevant time period, Trading Investigations was the sole NYSE unit recommending discipline of specialists for trading ahead and interpositioning violations. The discipline almost always took the form of informal discipline consisting of admonition letters and summary fines.¹³ Historically, the NYSE's Regulatory Group considered informal disciplinary actions as "warnings" to the specialists firms that further trading misconduct could lead to formal enforcement action. During the period 1999 to 2002, however, the informal disciplinary actions were not used to "warn" the firms that if they engaged in additional violations in the future, they would face formal regulatory action. Instead, repeat violations were generally addressed by additional informal action rather than a referral to Enforcement for formal disciplinary proceedings. With respect to trading ahead and interpositioning violations, the NYSE's Regulatory Group treated the informal disciplinary actions as similar in nature to "traffic tickets," which were not followed up with more formal regulatory action.

26. Trading Investigations also failed to consider whether the trading ahead and interpositioning instances it was investigating warranted a referral to the Enforcement Division for formal discipline under Rule 92. Instead, when Trading Investigations received a trading ahead referral, it treated the conduct as a minor technical violation of Rule 104.10. Even where the specialist firms engaged in recidivist conduct, the NYSE still failed to refer matters for formal disciplinary action. For example, as early as January 1996, one specialist firm was issued a summary fine for 28 instances of trading ahead, including 16 instances of interpositioning. In August 1998, the firm was cautioned for an additional 24 instances of trading ahead. In July 1999, the specialist firm received a summary fine of \$1,000 for 30 additional instances of trading

12 In one instance in 1999, a specialist traded ahead of four customer orders, which resulted in a total disadvantage to the customers of \$4,602.50. In another instance in 2000, a specialist traded ahead of a single customer order, which disadvantaged the customer by \$2,062.50.

13 There were a total of 6 admonition letters and 24 summary fines for trading ahead and interpositioning misconduct from 1999 through December 2002. Summary fines typically ranged from \$500 to \$1,000 for trading ahead misconduct. The total of the 24 summary fines was approximately \$17,500 (\$2,500 in 1999, \$3,000 in 2000, \$500 in 2001, and \$11,500 in 2002).

ahead. Despite this recidivist conduct, Market Surveillance did not increase its surveillance of the specialist firm or refer any of the conduct to the Enforcement Division. Moreover, while proof of intent was the critical element in referring conduct for formal enforcement action, investigators made little or no effort to try to determine the specialists' intent. NYSE investigators considered the conduct as violations of Rule 104.10 in large part because that was the rule Specialist Surveillance cited in its referrals. As a result, from 1999 to December 2002, Trading Investigations did not refer any trading ahead or interpositioning violations to the Enforcement Division.

27. Market Surveillance, including Specialist Surveillance and Trading Investigations, in all, but a few instances, failed to take disciplinary action against single instances of trading ahead, even when there were indications that the specialists intentionally traded ahead. This failure continued even after RQR issued a report in 1996 in which it proposed regulatory action for single instances of trading ahead: “[g]iven our commitment to protect all investors, we believe Market Surveillance should consider taking regulatory action for any single instance where it has been confirmed that the specialist did not provide an effective execution of a customer order.” In spite of this proposal, the NYSE rarely investigated or took disciplinary action with respect to single instances of trading ahead.

Actions Taken by the NYSE

28. In June 2002, after discovering significant interpositioning activity by a single specialist that had occurred as early as January 2000, the NYSE began developing a special study to assess the extent of interpositioning practices throughout the trading floor. The study, which culminated in a December 2002 report on interpositioning in all NYSE stocks for a three-month period, revealed widespread interpositioning conduct by various specialists, and prompted the NYSE to open a broader investigation into the unlawful trading. Since that time, the NYSE has undertaken various measures to address its regulatory failures in policing trading ahead and interpositioning, including changes to its surveillance system and implementation of computer software to better enable the NYSE to detect ongoing trading ahead and interpositioning. The NYSE and the Commission further investigated such violations and instituted formal disciplinary proceedings, which led to settled enforcement actions against all seven equity specialist firms.

29. The NYSE has recently made extensive changes to its governance and regulatory structure. These changes include: (1) amendments to the NYSE constitution that require all directors to be independent from members, member organizations, listed companies and (except for the CEO) management, and give the independent directors sole authority over the NYSE's conduct of its regulatory functions; (2) the creation of the new position of Chief Regulatory Officer, which reports to the Board of Directors, rather than senior NYSE management; (3) the creation of a standing Board of Directors committee, the Regulatory Oversight Committee, with direct oversight of all budgetary, compensation and staffing decisions affecting the NYSE's regulatory function, including those affecting RQR; (4) the appointment of a new head of regulation as the Chief Regulatory Officer and new leadership in the NYSE's Divisions of Market Surveillance, Member Firm Regulation and Enforcement; (5) moving Trading

Investigations from Market Surveillance to Enforcement, in order to foster more consistent determinations of whether formal or informal discipline is appropriate; (6) the creation of a new Specialist Surveillance unit to focus exclusively on the effectiveness of existing surveillances and the need for new or modified surveillances; (7) the creation of the Risk Assessment Unit, which analyzes trends and conducts risk assessment for the NYSE's Regulatory Group (now known as NYSE Regulation); (8) increases in staff and other resources available to the NYSE's regulatory units, including Market Surveillance; and (9) the retention by the Regulatory Oversight Committee of an independent consultant, who has reviewed the NYSE's oversight of specialist trading. The NYSE is also considering changes that would provide that, any time a specialist comes into possession of a customer order that could trade in place of some or all of the specialist's side of a proprietary trade that has not yet been reported, the specialist must allocate the trade to the customer order, unless a Commission-approved exception applies.

C. CERTAIN UNDERTAKINGS

30. In determining to accept the Offer, the Commission has considered the following voluntary undertakings by the NYSE:

The NYSE shall continue to cooperate fully with the Commission in any and all investigations, litigations or other proceedings relating to the matters described in the Order or relating to or arising from the conduct underlying such matters. In connection with such cooperation, the NYSE has undertaken:

- a. To produce, without service of a notice or subpoena, any and all documents and other information requested by the Commission's staff;
- b. To use its best efforts to cause its employees to be interviewed by the Commission's staff at such times as the staff reasonably may direct;
- c. To use its best efforts to cause its employees to appear and testify truthfully and completely without service of a notice or subpoena in such investigations, depositions, hearings or trials as may be requested by the Commission's staff; and
- d. That in connection with any testimony of the NYSE to be conducted at deposition, hearing or trial pursuant to a notice or subpoena, the NYSE:
 - i. Agrees that any such notice or subpoena for the NYSE's appearance and testimony may be served by regular mail on its attorney, Dixie Johnson, Esq., Fried, Frank, Harris, Shriver & Jacobson LLP, 1001 Pennsylvania Avenue, NW, Washington, DC 20004; and
 - ii. Agrees that any such notice or subpoena for the NYSE's appearance and testimony in any action pending in a United States District

Court may be served, and may require testimony, beyond the territorial limits imposed by the Federal Rules of Civil Procedure.

D. CONCLUSION

31. Section 19(g)(1) of the Exchange Act requires the NYSE, “absent reasonable justification or excuse,” to enforce compliance by its members with provisions of the Exchange Act, the rules and regulations thereunder, and the NYSE’s own rules.¹⁴ The Commission has stated that “the obligation to enforce imposed by Section 19(g) on an exchange necessarily includes an obligation to monitor and maintain surveillance over its members.” *Boston Stock Exchange, Inc.*, 21 S.E.C. Docket 22, Release No. 34-17183, 1980 WL 25454 at *3 (Oct. 1, 1980). Exchanges violate Section 19(g) when they fail “to be vigilant in surveilling for, evaluating, and effectively addressing issues that could involve violations” of the securities laws. *National Ass’n of Sec. Dealers, Inc.*, 62 S.E.C. Docket 1346, Release No. 34-37538, 1996 WL 447193, at *2 (Aug. 1996).

32. From 1999 through almost all of 2002, the NYSE failed to properly detect, investigate, and discipline unlawful interpositioning and trading ahead by specialists.

33. By not thoroughly investigating indications of possible violations by specialists, the NYSE failed to adequately enhance its regulation of specialists, as required by the 1999 Order.

34. The NYSE violated Section 19(g) of the Exchange Act by failing, without reasonable justification or excuse, to enforce Section 11(b) of the Exchange Act, Rule 11b-1 thereunder, and NYSE Rules 92 and 104.10.

35. Section 21(d)(3) of the Exchange Act authorizes the Commission to seek a civil penalty in federal district court against any person that violates the Exchange Act. In light of the NYSE’s commitment to set aside a reserve fund of \$20 million for the establishment, retention and payment of a Third Party Regulatory Auditor to conduct bi-annual regulatory audits of NYSE Regulation’s surveillance, examination, investigation and disciplinary programs, the Commission has determined not to seek a civil penalty from the NYSE. In addition, the Commission has also taken into consideration the NYSE’s enhancements to its governance and regulatory programs, listed in Paragraph 29 of this Order.

14 An SRO is relieved of its obligation to enforce compliance only when there is “reasonable justification or excuse” to fail to detect and stop violative conduct. *See Enforcement Obligations of Exchanges and Associations*, 10 S.E.C. Docket 998, Release No. 34-12994, 1976 WL 162853 (Nov. 18, 1976). There is no “reasonable justification or excuse” when an SRO knew, or, in view of all the facts and circumstances, should have known that its systems of reports, examinations and inspections were materially inadequate relative to the resources reasonably available to that SRO for detecting the misconduct. *Id.*

IV.

In view of the foregoing, the Commission deems it appropriate in the public interest and for the protection of investors to impose the sanctions agreed to in the NYSE's Offer.

Accordingly, it is hereby ORDERED, that

- A. The NYSE be, and hereby is, censured pursuant to Section 19(h) of the Exchange Act.
- B. The NYSE be, and hereby is, ordered pursuant to Section 21C of the Exchange Act to cease and desist from committing or causing any violation and any future violations of Section 19(g) of the Exchange Act.
- C. The NYSE shall comply with the following undertakings:
 1. Commencing in 2005, and every two years thereafter through 2011 (for a total of four two-year periods), the NYSE shall retain a Third Party Regulatory Auditor ("Regulatory Auditor"), not unacceptable to the Commission staff, to conduct a comprehensive regulatory audit of NYSE Regulation's surveillance, examination, investigation and disciplinary programs applicable to specialists, member firm floor brokers, independent floor brokers, registered competitive market makers and competitive traders (collectively, "Floor Members").
 - a. The Regulatory Auditor shall assess (i) whether NYSE Regulation's policies and procedures are reasonably designed and effective to detect and deter violations of all applicable federal securities laws and NYSE rules relating to trading by Floor Members; (ii) whether NYSE Regulation is in compliance with (1) the above-referenced policies and procedures; and (2) any outstanding written recommendations made by the Commission's Office of Compliance Inspections and Examinations ("OCIE") or the Commission's Division of Market Regulation ("Market Regulation") relating to compliance with rules, or surveillance for rule violations, with respect to trading by Floor Members; and (iii) whether the NYSE is in compliance with any outstanding undertakings contained in this Order and in the 1999 Order issued against the NYSE by the Commission.
 - b. The Regulatory Auditor must develop a written regulatory audit plan of sufficient scope and detail to achieve the regulatory audit objectives and to identify regulatory areas in need of special consideration. In performing the regulatory audit, the Regulatory Auditor and other qualified persons hired by the Regulatory Auditor ("qualified persons") shall have or acquire within a reasonable period of time adequate

knowledge and understanding of the NYSE's regulatory programs, policies and procedures. The Regulatory Auditor and the qualified persons shall exercise due professional care and independence in performing the regulatory audit. The Regulatory Auditor shall formulate conclusions concerning its assessment, as described in Paragraph IV.C.1.a. above, based on sufficient evidence that is obtained through, among other things, (i) inspection of documents, including written procedures, rules, and staff files; (ii) observation of trading processes and the NYSE's regulatory systems and practices; (iii) interviews of regulatory staff, RQR staff, Floor Members and other relevant persons; and (iv) studies and testing of various regulatory functions and trading practices. The NYSE shall cooperate fully with the Regulatory Auditor and qualified persons and provide the Regulatory Auditor and qualified persons with access to its files, books, records, and staff as reasonably requested for the regulatory audit.

c. No later than 45 days after the regulatory audit is concluded, the Regulatory Auditor shall submit to the NYSE's Board of Directors and to the Director of OCIE and the Director of Market Regulation (the "Commission Officials") the Regulatory Auditor's conclusions concerning its assessment as to (i) whether NYSE Regulation's policies and procedures are reasonably designed and effective to detect and deter violations of all applicable federal securities laws and NYSE rules relating to trading by Floor Members; (ii) whether NYSE Regulation is in compliance with (1) the above-referenced policies and procedures; and (2) any outstanding written recommendations made by OCIE or Market Regulation relating to compliance with rules, or surveillance for rule violations, with respect to trading by Floor Members; and (iii) whether the NYSE is in compliance with any outstanding undertakings contained in this Order and in the 1999 Order issued against the NYSE by the Commission. The Regulatory Auditor's conclusions shall also be included in the NYSE's annual report.

d. No later than 45 days after the regulatory audit is concluded, the Regulatory Auditor shall also submit a regulatory audit report to the NYSE's Board of Directors and to the Commission Officials (i) describing the purpose, scope and nature of the regulatory audit; and (ii) identifying any significant deficiencies or weaknesses in NYSE Regulation's policies and procedures, or the NYSE's compliance with those policies and procedures, any outstanding written recommendations made by OCIE or Market Regulation relating to compliance with rules, or surveillance for rule violations, with respect to trading by Floor Members, and any outstanding undertakings contained in this Order and in the 1999 Order issued against the NYSE by the Commission. Copies of this report shall

also be filed confidentially with the Commission Officials for use by the Commission pursuant to the Commission's statutory oversight function, but without any limitation on the Commission's uses.

e. Within 90 days after submission of the Regulatory Auditor's conclusions to the NYSE's Board of Directors and the Commission Officials, RQR shall review with the Regulatory Auditor the conclusions of the Regulatory Auditor and the bases underlying any finding of a deficiency or weakness and shall review the proposed response of NYSE Regulation.

f. The NYSE shall bear the full expense of the regulatory audits. Within 45 days after issuance of this Order, the NYSE shall set aside a reserve fund of \$20 million for the establishment, retention and payment of the Regulatory Auditor for the four regulatory audits. If the expenses for the four regulatory audits exceed the funds in the reserve fund, the NYSE shall provide additional funds to pay the costs of the regulatory audits. Any reserve funds remaining after completion of the four regulatory audits shall be used to fund an additional regulatory audit, or as the Commission may direct.

g. The Regulatory Auditor shall provide the Commission staff with any documents or other information the Commission requests regarding the Regulatory Auditor's work pursuant to this undertaking for use by the Commission pursuant to the Commission's statutory oversight function, but without any limitation on the Commission's uses. In connection with the Regulatory Auditor's work, the NYSE shall not withhold from the Commission or the Commission's staff, and shall require the Regulatory Auditor to agree not to withhold from the Commission or the Commission's staff, any documents or information on the basis of any privilege or work product claims in response to any of the Commission staff's requests.

2. Within 90 days after issuance of this Order, the NYSE shall improve and enhance its regulation of Floor Members by developing and beginning implementation of policies and procedures to accomplish the following: (a) authorizing each and every division and unit director within NYSE Regulation to make immediate referrals of potential unlawful trading by Floor Members directly to the Enforcement Division; and (b) mandatory annual training of NYSE Regulation staff responsible for surveillance, investigation, examination, and discipline of Floor Members, including training on (i) the operations of the Display Book (or successor system used by specialists to execute orders); (ii) ways in which the Display Book has been used by Floor Members to circumvent or violate the federal securities laws and NYSE Rules; and (iii) the federal

securities laws and NYSE Rules in place to prevent and deter unlawful trading by Floor Members.

3. Within 60 days of full implementation of the NYSE's proposed hybrid electronic and floor-based auction market system of trading, if approved by the Commission, or by April 1, 2006, whichever is earlier, the NYSE shall implement a pilot program for an on-floor video and audio surveillance system (the "Pilot Program") to track floor trading activity at NYSE trading posts. The Pilot Program shall be conducted over a period of eighteen months, or as directed by the Commission pursuant to Paragraph 3.c. below. The Pilot Program shall be designed in consultation with the Commission's Office of Information Technology. At a minimum, the Pilot Program will encompass the trading activity of at least 20 NYSE stocks, including at least 3 of the 5 most active NYSE stocks and an additional 7 of the 25 most active NYSE stocks with respect to trading volume for the year prior to issuance of this Order. Each specialist's post and panel participating in the Pilot Program shall have sufficient audio and video equipment to capture, on a best efforts basis, floor trading activity occurring at that specialist's post and panel. For the Pilot Program, "floor trading activity" shall include all activity and interaction between each specialist and other Floor Members, and between Floor Members, occurring in the immediate vicinity of the specialist's post and panel. This audio and video surveillance system shall be designed to provide, in conjunction with information derived from the Display Book (or successor system used by specialists to execute orders) and the NYSE's audit trail system, accurate time-sequenced records of all orders arriving at each specialist's trading post (whether from the trading crowd or through the DOT system). The time clocks of this video and audio surveillance system shall be synchronized with all other relevant time clocks operating on the floor, including time clocks associated with the Display Book (or successor system) and the NYSE's audit trail system. The NYSE shall maintain records of the Pilot Program for a period of not less than two years, the first year in an easily accessible place. In connection with this undertaking, the NYSE shall file any necessary proposed rule changes with the Commission.

a. The NYSE shall utilize the Pilot Program (i) to investigate indications of potential violations of the NYSE rules and the federal securities laws and (ii) to conduct certain targeted monitoring of trading activity, as defined below. The indications of potential violations include, among other things, (i) alerts from the NYSE's automated surveillances; (ii) investigative and examination findings developed by NYSE Regulation; (iii) inquiries and complaints from Floor Members and the public; and (iv) referrals of possible misconduct made by other SROs, the Commission, and other law enforcement agencies. For the targeted monitoring, the NYSE shall review, based on certain reasonable standards

to be determined by the NYSE, at least 3 hours of trading activity each month in each of the 20 stocks described above.

b. Starting 240 days after implementation of the Pilot Program, RQR shall conduct a comprehensive, independent and objective review and evaluation of the Pilot Program (the “Review”) and the costs, benefits, feasibility and practicability of expanding the Pilot Program to the entire floor of the NYSE (including the costs, benefits, feasibility and practicability of maintaining the surveillance records for a reasonably lengthy period of time). The RQR staff responsible for the Review (the “RQR Staff”) shall have access to all NYSE files, books, records, and personnel as reasonably requested for the Review.

c. Within 360 days of implementation of the Pilot Program, RQR shall submit a report directly to the NYSE’s Board of Directors and the Commission Officials which sets forth RQR’s independent evaluation of the Pilot Program and RQR’s recommendation as to whether to expand, modify, or eliminate the Pilot Program. Upon request, RQR shall also provide the Commission staff with sufficient underlying data to enable the Commission staff and Commission Officials to independently evaluate RQR’s recommendations. Within 120 days of receipt of RQR’s report, the Commission Officials shall submit to the Commission, for the Commission’s approval, their own recommendation as to whether to modify or eliminate the Pilot Program, or expand the program to the entire floor of the NYSE.

d. Neither the NYSE nor RQR shall invoke or seek to invoke the attorney-client privilege or any other doctrine or privilege to prevent RQR from transmitting any information, reports, or documents to the Commission Officials or the Commission, in connection with the Review or the independent evaluation by the Commission Staff and Commission Officials.

e. In order to ensure that the Review is independent and objective, the NYSE shall (i) maintain the existing reporting structure in which RQR Staff report directly to the Regulatory Oversight Committee; (ii) prohibit non-RQR staff from offering unsolicited comments or observations to the RQR Staff, or in any way communicating, directly or indirectly, conclusions, evaluations and/or recommendations to the RQR Staff, or attempting to direct or sway the conclusions, evaluations and/or recommendations of the RQR Staff in connection with the Review; and (iii) prohibit non-RQR staff from reviewing or commenting on draft reports by RQR Staff of or concerning the Review.

4. Within 90 days after issuance of this Order, the NYSE shall develop systems and procedures designed to track (a) the identity of specialists and their clerks; (b) the times during which each specialist acts in his or her capacity as specialist on the floor of the NYSE; and (c) the times during which each specialist's clerk acts in the capacity of clerk to a specialist on the floor of the NYSE, and shall file any necessary proposed rule changes with the Commission. The NYSE shall maintain records of such information for a period of not less than five years, the first two years in an easily accessible place. The NYSE shall implement this undertaking within 180 days from the date of the issuance of this Order.

5. The NYSE undertakes to continue to identify and implement enhancements to its trading systems reasonably designed to prevent specialists from trading ahead and interpositioning. Prior to the date of this Order, the NYSE commenced implementation of this undertaking by modifying the Display Book to include the Principal Inhibitor function. The Principal Inhibitor function is an electronic default that blocks specialist dealer trades when the specialist is in the process of executing a proprietary trade while in possession of a customer order that could trade in place of some or all of the specialist's side of the trade. The specialist may override the electronic default by inputting information representing that the trade meets a specified exemption approved by the NYSE. With respect to this undertaking, the NYSE specifically undertakes to develop system enhancements to the extent practicable to limit those circumstances, not approved by the NYSE, in which the specialist may override the electronic default of the Principal Inhibitor function. The NYSE shall require that the system enhancements adopted in compliance with this undertaking may not be disabled by the specialists.

6. Within 90 days after issuance of this Order, the NYSE shall establish and maintain a staff position within NYSE Regulation specifically responsible for (a) tracking and updating the status of all complaints, referrals, investigations and discipline involving all Floor Members; (b) updating and disseminating information about the status of such matters to the Regulatory Oversight Committee and NYSE Regulation staff; and (c) acting as liaison to the Regulatory Oversight Committee and to each Division within NYSE Regulation on the status of such matters.

7. Commencing within 180 days of issuance of this Order, and at least once every year for a period of 5 years, the Chief Regulatory Officer of the NYSE shall certify to the Commission by affidavit that, to the best of his knowledge based upon reasonable inquiry, the NYSE has, in all material respects, fully adopted and complied with (a) any outstanding undertakings set forth in Paragraphs IV.C.1. through IV.C.6. above; and (b) any outstanding undertakings set forth in

Paragraphs IV.1. through IV.12. of the 1999 Order. The affidavit shall be delivered to the Commission Officials.

8. Upon written request and good cause being shown, the Commission staff may grant the NYSE such additional time as the Commission staff deems necessary to implement any of the undertakings enumerated herein.

By the Commission.

Jonathan G. Katz
Secretary