

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**

**Release No. 51714 / May 19, 2005**

**ADMINISTRATIVE PROCEEDING**

**File No. 3-11931**

**In the Matter of**

**NATIONAL STOCK  
EXCHANGE and**

**DAVID COLKER**

**Respondents.**

**ORDER INSTITUTING ADMINISTRATIVE  
AND CEASE-AND-DESIST PROCEEDINGS  
PURSUANT TO SECTIONS 19(h) AND 21C  
OF THE SECURITIES EXCHANGE ACT OF  
1934, MAKING FINDINGS, AND IMPOSING  
SANCTIONS**

**I.**

The Securities and Exchange Commission (the “Commission”) deems it appropriate, in the public interest, and for the protection of investors that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 19(h)(1) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”) against National Stock Exchange (“NSX” or the “Exchange”), and that public administrative proceedings be, and hereby are, instituted pursuant to Section 19(h)(4) of the Exchange Act against David Colker (“Colker”).

**II.**

In anticipation of the institution of these proceedings, NSX and Colker (collectively, “Respondents”) have submitted Offers of Settlement (the “Offers”) 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 to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over them and the subject matter of these proceedings, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 19(h) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Sanctions (“Order”), as set forth below.<sup>1</sup>

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<sup>1</sup> In a related action, Colker has consented to the entry of a final judgment ordering him to pay a civil penalty of \$100,000 pursuant to Section 21(d)(3) of the Exchange Act. *See SEC v. Colker*, Case No. 05-C-2977 (N.D. Ill. filed May 19, 2005).

### III.

On the basis of this Order and Respondents' Offers, the Commission finds that:<sup>2</sup>

#### A. Respondents

1. NSX is a self-regulatory organization ("SRO") located in Chicago, Illinois and registered with the Commission as a national securities exchange pursuant to Section 6(a) of the Exchange Act.<sup>3</sup> Since 1976, NSX has operated as an all-electronic exchange. NSX currently trades both listed and over-the-counter securities, and is among the largest stock exchanges in the U.S. in terms of trading volume.

2. Colker, age 53, resides in Evanston, Illinois. Colker is the president and chief executive officer of NSX. Colker has been employed at NSX since 1984 and, since 1992, has had ultimate responsibility for the day-to-day operations of the Exchange. Colker was previously NSX's vice president of regulation and general counsel.

#### B. Summary

3. This matter concerns the failure by NSX to enforce compliance by its dealer firms (known as "designated dealers") with two important provisions of its rules: the market order exposure ("MOE") rule and the customer priority (or trading ahead) rule.

4. First, from 1997 through 2003, NSX did not enforce its MOE rule in a manner consistent with the rule's language. The MOE rule required designated dealers to provide customer market orders with the opportunity for price improvement whenever the spread between the national best bid and offer ("NBBO") was greater than the minimum price variation ("MPV").<sup>4</sup> In 1996, when NSX adopted the MOE rule, the MPV was 1/8 of a point and, as a result, the rule required an opportunity for price improvement at 1/4-point spreads or greater. In 1997, the MPV was decreased from 1/8 to 1/16 of a point. The NSX's Board of Trustees (the "NSX Board") decided that the MOE rule should continue to be enforced only at spreads of 1/4 point or greater, and delegated to the NSX staff responsibility to implement that policy decision by filing, if necessary, a proposed rule amendment with the Commission. Because the language of the MOE rule referred to the MPV and not to spreads of 1/4 point or greater, the NSX should have filed a proposed rule amendment seeking Commission approval prior to changing the circumstances under which it enforced the

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<sup>2</sup> The findings herein are made pursuant to Respondents' Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

<sup>3</sup> NSX was formerly known as The Cincinnati Stock Exchange and changed its name to the National Stock Exchange in November 2003.

<sup>4</sup> NSX Rule 11.9(u), Interpretations and Policies .01. The NBBO is the quotation reflecting the highest price a prospective buyer will pay for a security (called the "bid") and the lowest price a prospective seller will accept for that security (the "offer"), across the national market system. The difference between the bid and the offer is the "spread." "Minimum price variation" refers to the smallest amount by which the quoted price of a security could change. *See Short Sales*, Exchange Act Release No. 42037, 70 S.E.C. Docket 2090, 1999 WL 958430, at \*12 (Oct. 20, 1999); NSX Rule 11.3.

MOE rule. At Colker's direction, however, NSX did not file a proposed rule amendment, in part because Colker wanted to avoid exposing the amendment to a public notice-and-comment process that would have afforded competing exchanges an opportunity to criticize the NSX's dealer preferencing program, as they had done previously. Instead, NSX issued a regulatory circular to its member firms announcing that it would continue applying the MOE rule at spreads of 1/4 point or greater, and later included that circular in certain routine Commission filings without drawing attention to its MOE rule interpretation. Ultimately, NSX's failure to enforce the MOE rule caused public customers to lose opportunities for potential price improvement on thousands of market orders executed on NSX from 1997 to 2003.

5. Second, until 2004 NSX did not conduct surveillance for violations of its customer priority rule, which prohibited designated dealers from trading ahead of customer orders in their possession. As a result, from 1999 to 2003 NSX failed to detect hundreds of thousands of transactions in which NSX designated dealers traded ahead of customer orders.

6. By its actions, and without reasonable justification or excuse, NSX failed to enforce compliance by NSX designated dealers with its MOE and customer priority rules within the meaning of Section 19(h)(1) of the Exchange Act, and in violation of Section 19(g)(1) of the Exchange Act. Moreover, NSX violated Section 19(b)(1) of the Exchange Act by failing to file with the Commission a proposed rule amendment regarding the circumstances under which it would enforce the MOE rule. Colker was responsible for NSX's failure to seek Commission approval for its limited enforcement of the MOE Rule and, as a result, failed to enforce compliance by NSX designated dealers with the MOE Rule within the meaning of Section 19(h)(4) of the Exchange Act.

7. Finally, NSX failed to ensure retention of business-related e-mail for at least five years. As a result, NSX violated Section 17(a)(1) of the Exchange Act and Rule 17a-1 thereunder.

## C. Discussion

### Background

8. In 1996, the Commission granted permanent approval to NSX's dealer preferencing program.<sup>5</sup> Pursuant to that program, NSX's preferencing dealers were permitted to retain and execute their internal order flow (*i.e.*, the customer orders they generated and/or represented as brokers) at the prevailing NBBO, as long as they gave execution priority to customer limit orders posted on NSX's central limit order book at the same price. As a condition of the Commission's final approval of its dealer preferencing program, NSX was required to adopt a series of order-handling rules, including the MOE rule.<sup>6</sup> As a further condition of the Commission's approval,

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<sup>5</sup> See *Self-Regulatory Organizations; the Cincinnati Stock Exchange; Order Granting Approval to Proposed Rule Change to Adopt Permanently Rules Regarding the Preferencing of Public Agency Orders*, Exchange Act Release No. 37046, 61 S.E.C. Docket 1577, 1996 WL 166535 (Mar. 29, 1996).

<sup>6</sup> In granting permanent approval to NSX's preferencing program, the Commission stressed that approval was predicated, in part, on NSX's adoption of the MOE rule. See *id.*, 1996 WL 166535, \*11 ("The Commission has concluded that preferencing, *as supplemented by the order handling policies*, is not necessarily inconsistent with the attainment of best execution of customer orders, the maintenance of fair and orderly markets, or the protection of

NSX committed to automating its surveillance to ensure compliance with several NSX rules, including the customer priority rule. From 1996 through 2000, the trading fees and tape revenue generated by designated dealers participating in NSX's preferencing program accounted for most of the Exchange's overall revenue.<sup>7</sup>

### **NSX Did Not Enforce Its MOE Rule In Accordance With Prevailing Minimum Price Variations**

9. The MOE rule required preferencing dealers to provide customer market orders with the opportunity for price improvement whenever the spread between the NBBO was "greater than the minimum price variation."<sup>8</sup> When NSX adopted the MOE rule in 1996, the minimum price variation ("MPV") was 1/8 of a point. Consequently, the MOE rule applied to customer market orders received by preferencing dealers when the NBBO spread for that particular security was 1/4 of a point or more, because 1/4 (*i.e.*, 2/8) was the next increment "greater than the minimum price variation" of 1/8. In such instances, preferencing dealers were required to provide customers with the opportunity for price improvement either by executing the market order immediately at an improved price, or by exposing the order on the national market system for at least thirty seconds for possible price improvement.<sup>9</sup>

10. In mid-1997, the MPV was decreased from 1/8 to 1/16 of a point across the national market system, including on NSX. Because the MOE rule applied whenever the NBBO spread was "greater than the minimum price variation," the rule required preferencing dealers to provide price improvement (or exposure) when the NBBO spread was greater than the new MPV of 1/16 – that is

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investors and the public interest under Section 6(b)(5) of the Act . . . [and] also is consistent with Section 11A of the Act, *particularly considering the order handling policies being adopted herein.*") (emphasis added).

<sup>7</sup> Although the dealer preferencing program remains in effect, the majority of NSX's trading fees and tape revenue since 2001 have derived from trades in NASDAQ-listed securities that are not executed through the preferencing program.

<sup>8</sup> NSX Rule 11.9(u), Interpretations and Policies .01. The MOE rule, as approved by the Commission and adopted by NSX, provided as follows: "[W]hen the spread between the national best bid and offer *is greater than the minimum price variation*, a member must either immediately execute the market order at an improved price or expose the market order on the Exchange for a minimum of thirty seconds in an attempt to improve the price." (emphasis added).

<sup>9</sup> The MOE rule did not specify the amount of price improvement, but, as a practical matter, dealers could not improve on the NBBO by an amount less than the MPV. For example, if a preferencing dealer had received a market order to sell 100 shares of X Corp., for which the national best bid was 10 and the national best ask was 10½, the MOE rule would have applied because the spread between the NBBO was 1/2 of a point, which was greater than the minimum price variation of 1/8 at that time. The preferencing dealer would have been required either to: (1) immediately take the contra side of the customer sell order at an improved price of at least 10<sup>1</sup>/<sub>8</sub> (because the MPV was 1/8), or (2) immediately expose the order on the national market system for at least thirty seconds at the improved price of at least 10<sup>1</sup>/<sub>8</sub>. If the dealer chose the latter, it could have exposed the market order by representing the order at 10<sup>1</sup>/<sub>8</sub> in its NSX quote, or by placing the order on NSX's central limit order book at 10<sup>1</sup>/<sub>8</sub>. In either case, the dealer would have been required to stop the original order at the national best bid of 10 so that the customer received at least the best price available when the dealer first received the order. If thirty seconds passed and the customer order was not executed at an improved price, the dealer would have been required to execute the trade at the stopped price of 10.

to say, at 1/8 or greater.<sup>10</sup> NSX, however, decided to continue to require its designated dealers to provide an opportunity for price improvement only when the NBBO spread was 1/4 point or more, and not at spreads of 1/8 or greater. Such an interpretation was inconsistent with the language of the MOE rule and was, in effect, an amendment of the existing rule. Consequently, NSX was required to seek Commission approval by filing a proposed rule amendment.<sup>11</sup>

11. On May 16, 1997, in anticipation of the impending change in the MPV, the NSX Board considered what action was necessary with regard to the MOE rule. The NSX Board resolved to continue to apply the MOE rule when the NBBO spread was 1/4 point or greater, and authorized the NSX staff to file, if necessary, a proposed rule change with the Commission to seek approval for this limitation. Colker decided that NSX did not have to file a proposed rule change, even though he had been advised by NSX's then-general counsel that Commission rules required the Exchange to do so.<sup>12</sup> Colker opposed making such a filing with the Commission, in part, because he did not want to subject a proposed rule amendment to a public notice-and-comment process, which would have given competing exchanges another opportunity to challenge NSX's dealer preferencing program, as they had done previously.

12. Instead, Colker directed the NSX staff to issue a regulatory circular to NSX member firms announcing that the Exchange was continuing to apply the MOE rule only at NBBO spreads of 1/4 point or greater. That regulatory circular,<sup>13</sup> issued to NSX members in June 1997, stated:

[The MOE rule], as approved, was designed to require [designated dealers participating in the preferencing program] to expose, at an improved price, market orders on the [NSX] when the spread between the [NBBO] is 1/4 point or greater. This exposure requirement will not be broadened when trading and quoting begins . . . in increments smaller than 1/8th of \$1.00. Thus, [preferencing designated dealers] will continue to be required to expose market orders in markets where the bid-offer spread is 1/4th of \$1.00 or greater.

The circular made no reference to the actual text of the MOE rule and stated an interpretation that deviated from the rule's language. The MOE rule required exposure of orders when the NBBO spread was greater than the "minimum price variation," and not at 1/4 point or greater as asserted in the first sentence of the circular.

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<sup>10</sup> Between 1/16 and 1/4, there were two additional increments at which the MOE rule would have applied: 1/8 (*i.e.*, 2/16) and 3/16.

<sup>11</sup> The standard that governed SRO rule changes was, and continues to be, Exchange Act Section 19(b) and Rule 19b-4, which requires an SRO to file a proposed rule change with respect to any "stated policy, practice, or interpretation." A "stated policy, practice, or interpretation" explicitly includes, among other things, any pronouncement to exchange members that "establishes or changes any standard, limit, or guideline" regarding the "the meaning, administration, or enforcement of an existing rule." An SRO was relieved of this obligation if the stated policy, practice, or interpretation in question was "reasonably and fairly implied by an existing rule" of the SRO.

<sup>12</sup> After being overruled by Colker, NSX's then-general counsel acceded to Colker's position because Colker was his supervisor and because it was "not a bright line issue [or] clear-cut case in [his] opinion." The general counsel maintained, however, that Colker's decision not to file a proposed rule change was "very aggressive given the wording of the [MOE] rule."

<sup>13</sup> NSX Regulatory Circular 97-07.

13. At or about the same time, NSX's general counsel, acting on his own initiative, prepared and presented to Colker a draft letter to the Commission staff enclosing the regulatory circular and explaining the rationale for NSX's interpretation. Colker, however, decided not to send the letter. Instead, NSX included the regulatory circular together with several other routine monthly and annual filings with the Commission, but did not draw attention to its MOE rule interpretation.<sup>14</sup>

14. In late 1999, a subsequent NSX general counsel suggested to Colker that a rule filing with the Commission was the preferred course of action to reconcile the text of the MOE rule with the manner in which it was being enforced by NSX. Colker declined that suggestion. At about the same time, the Commission's Division of Market Regulation ("Market Regulation") requested that NSX identify which NSX rules required amendment in light of the anticipated implementation of decimal pricing across the national market system. In a letter responding to the Commission staff's request, Colker stated that the MOE rule required price improvement whenever the NBBO spread "[was] greater than the MPV," which was then at 1/16. In fact, NSX was only enforcing the rule when the NBBO spread was greater than 3/16 (*i.e.*, at spreads of 1/4 or greater).<sup>15</sup>

15. In October 2000, the MPV changed again across all markets, including at NSX, from 1/16 to \$.01, as the national market system implemented decimal pricing.<sup>16</sup> Pursuant to the MOE rule, at that time NSX should have begun requiring preferencing dealers to provide the opportunity for price improvement when the NBBO spread was \$.02 or greater. Nevertheless, NSX and Colker continued to enforce the MOE Rule only when the NBBO spread was 1/4 of a point (\$.25) or greater. NSX did not file a proposed rule amendment in response to the change to decimal pricing to reconcile the text of the MOE rule with its limited enforcement by the Exchange.

16. As a result of NSX's and Colker's actions, the Exchange did not conduct surveillance for, and take enforcement action against, violations of the MOE rule in markets greater than the MPV but less than 1/4 of a point from June 1997 to November 2003, when the Commission approved NSX's request to eliminate the MOE Rule.<sup>17</sup> Up to seven NSX designated

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<sup>14</sup> On several occasions beginning in July 1997, NSX either made reference to the circular in documents provided to the Commission or provided the circular to the Commission staff along with many other regulatory materials. On none of those occasions did NSX disclose to the Commission staff that it was enforcing the MOE rule in a manner that was inconsistent with the rule's actual language.

<sup>15</sup> In that letter, Colker mentioned that NSX intended to request elimination of the MOE rule and had "begun a dialogue" with the Commission staff in that regard. However, the Commission staff was not supportive of NSX's desire to eliminate the rule at that time, and NSX did not file a proposed rule change seeking elimination of the MOE rule until August 2003. The rule was eliminated in December 2003, as explained in note 17.

<sup>16</sup> *See Order Directing the Exchanges and the National Association of Securities Dealers, Inc. to Submit a Phase-In Plan to Implement Decimal Pricing in Equity Securities and Options*, Exchange Act Release No. 42914, 72 S.E.C. Docket 1493, 2000 WL 816861 (June 8, 2000).

<sup>17</sup> In August 2003, NSX filed a proposed rule change seeking to eliminate the MOE rule, and the Commission, by delegated authority to Market Regulation, approved the change in November 2003. *See* Exchange Act Release No. 48817, 81 S.E.C. Docket 2165, 2003 WL 22794445 (Nov. 21, 2003). The Release noted that while the Commission was approving the elimination of the MOE rule, it made "no determination as to whether it would have approved the proposed rule change had it been filed at the time that the regulatory circulars setting forth NSX's practices with respect to the Market Order Exposure Requirement were issued." *Id.*, 2003 WL 22794445, at \*1.

dealers benefited from this course of conduct because they did not bear the costs of modifying their systems to comply with changing MPV parameters or the practical burdens of providing price improvement at an increased number of price intervals.<sup>18</sup> NSX also benefited, as it was able to compete for order flow by offering dealers a less restrictive trading platform. Public customers lost opportunities for potential price improvement on thousands of market orders executed on NSX from 1997 to 2003.

### **NSX Failed to Enforce Its Customer Priority Rule**

17. NSX's customer priority rule prohibits NSX designated dealers from trading ahead of their customer orders.<sup>19</sup> An important customer protection, the rule was designed to prevent dealers from buying or selling any security for their own accounts while in possession of an unexecuted agency market order (or a marketable limit order) to buy or sell that security.

18. Until late 2004, NSX failed to conduct any surveillance to detect whether its dealers were violating the customer priority rule.<sup>20</sup> Although NSX had assured the Commission staff, in 1996, that it would develop and implement an automated surveillance report to detect trading ahead, the Exchange failed to do so. Moreover, although NSX's own Regulatory Services Procedures Manual contained a manual surveillance procedure for trading ahead, the Exchange failed to perform even this manual procedure at any time.

19. In May 2001, in connection with an examination by the Commission's Office of Compliance Inspections and Examinations ("OCIE"), NSX informed the OCIE staff that it had not been conducting daily trading-ahead surveillance because it was too time-consuming and cumbersome. NSX also represented that trading ahead was being reviewed as part of NSX's periodic dealer examinations. However, the Exchange's examination program was an inadequate and ineffective means of fulfilling NSX's obligation to enforce the customer priority rule. NSX's examinations did not include testing for actual trading-ahead violations. Rather, NSX examiners merely inquired about a dealer's trading-ahead policies and procedures, and were instructed to look for trading-ahead violations while reviewing samples of trades to detect other violations.<sup>21</sup> Those samples were so limited that they were not statistically representative of actual dealer trading during the review period. NSX conducted its sampling of any particular firm's trading, on average, only once every twenty-two months, and those samples consisted of no more than seventy-five trades. By contrast, NSX's most active dealers executed thousands of trades per day. Moreover, even when NSX examiners identified trading-ahead violations by a particular member firm, the Exchange

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<sup>18</sup> As the MPV decreased to 1/16 of a point and later to \$.01, the MOE rule would have applied to a greater number of customer trades.

<sup>19</sup> NSX Rule 12.6.

<sup>20</sup> In late 2004, NSX implemented automated daily surveillance for potential violations of the customer priority rule.

<sup>21</sup> For example, examiners reviewed a sample of trades to determine how a firm used a particular execution code. Beginning in May 2001, NSX directed examiners to look for trading-ahead violations within the sample to detect whether dealers were using the execution code to mask trading ahead. However, dealers could have traded ahead of customer orders without using this particular code.

failed to perform a follow-up review of that member's trading to determine whether additional violations had occurred.

20. From 1996 to 2003, NSX's examination program identified fewer than fifty trading-ahead violations resulting in only seven enforcement proceedings. Based on a review conducted at the request of the Commission's staff after the Commission's investigation of this matter had begun, NSX identified hundreds of thousands of trading-ahead violations by its member firms from 1999 through 2003, to the detriment of public customers.

### **NSX Failed to Preserve E-Mail Correspondence**

21. During the relevant period, NSX also failed to take steps to ensure that e-mail correspondence made or received in the course of NSX's business or self-regulatory activity was retained for a minimum of five years, as prescribed by Exchange Act Rule 17a-1. NSX lacked a document retention policy regarding e-mail correspondence and failed to instruct its employees to retain business-related e-mails until November 2003. Thus, many NSX employees routinely deleted business-related e-mails that were deemed no longer important. In addition, NSX did not require retention of electronic backup tapes, but instead recycled them within thirty days. As a result, NSX failed to retain required e-mail correspondence for the required five-year period.

## **D. Violations**

### **Section 19(g)(1) of the Exchange Act**

22. Section 19(g)(1) of the Exchange Act requires every exchange to comply with the provisions of the Exchange Act, the rules and regulations thereunder, and its own rules, and also to enforce compliance by its members with such provisions, absent some "reasonable justification or excuse" for failing to do so. The Commission has consistently held that an exchange's obligation to enforce compliance under Section 19(g)(1) "necessarily includes an obligation to monitor and maintain surveillance over its members."<sup>22</sup> An exchange violates Section 19(g)(1) when it fails "to be vigilant in surveilling for, evaluating, and effectively addressing issues that could involve violations" of its own rules.<sup>23</sup>

23. NSX violated Section 19(g)(1) of the Exchange Act by failing to enforce compliance with its MOE rule from July 1997 through August 2003 without reasonable justification or excuse. NSX improperly limited the application of, and consequently the surveillance and enforcement of, the MOE rule to markets where the spread between the NBBO was 1/4 point or greater, thereby failing to monitor or take enforcement action against violations where the spread between the

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<sup>22</sup> *In the Matter of Chicago Stock Exch., Inc.*, Exchange Act Release No. 48566, 81 S.E.C. Docket 490, 2003 WL 22245922, at \*8 (Sept. 30, 2003) (quoting *In the Matter of Boston Stock Exch., Inc.*, Exchange Act Release No. 17183, 21 S.E.C. Docket 22, 1980 WL 25454, at \*3 (Oct. 1, 1980)); see also *In the Matter of New York Stock Exch., Inc.*, Exchange Act Release No. 41574, 70 S.E.C. Docket 106, 1999 WL 430863, at \*1 (June 29, 1999) (same); *In the Matter of National Ass'n of Secs. Dealers, Inc.*, Exchange Act Release No. 37538, 62 S.E.C. Docket 1346, 1996 WL 447193, at \*2 (Aug. 8, 1996) (same).

<sup>23</sup> *Chicago Stock Exch.*, 2003 WL 22245922, at \*8 (quoting *National Ass'n of Secs. Dealers*, 1996 WL 447193, at \*2).



NBBO was greater than the MPV but less than 1/4 point. NSX further limited its enforcement of the MOE rule without reasonable justification or excuse beginning in October 2000, when the MPV changed from 1/16 to \$.01, by continuing to apply the rule at 1/4 point (\$.25) or greater when it should have applied the rule at \$.02 or greater.

24. There was no reasonable justification or excuse for NSX's failure to enforce the MOE rule according to its text. In granting permanent approval to NSX's preferencing program in 1996, the Commission noted that the approval was predicated, in part, on NSX's adoption of the MOE rule.<sup>24</sup> The text of the MOE rule, as adopted by NSX and approved by the Commission, required designated dealers to provide an opportunity for price improvement "whenever the spread between the [NBBO was] greater than the minimum price variation." The MOE rule did not specify the minimum price variation. Thus, when the MPV changed, the rule required dealers to provide an opportunity for price improvement whenever the NBBO spread exceeded the then-prevailing MPV.

25. As described above, NSX also violated Section 19(g)(1) of Exchange Act by failing to implement surveillance procedures to detect violations of its customer priority (trading ahead) rule without reasonable justification or excuse. By failing to conduct surveillance for trading ahead, NSX failed to prevent widespread violations of its customer priority rule.

#### **Section 19(b)(1) of the Exchange Act**

26. Section 19(b)(1) requires an exchange to file proposed rule changes with the Commission, and Rule 19b-4 provides that any "stated policy, practice or interpretation" of an exchange shall be deemed a "proposed rule change" unless "it is reasonably and fairly implied by an existing rule" of the Exchange. An exchange must file a proposed rule change with the Commission on Form 19b-4, and in turn, the Commission publishes the proposed rule in the Federal Register to allow all interested parties to comment upon it. Pursuant to Section 19(b)(2), the Commission will approve the proposed rule change only upon a finding that "is consistent with the requirements of [the Exchange Act] and rules and regulations thereunder."

27. NSX's failure to file a proposed rule change in 1997 concerning its limitation of the MOE rule to 1/4-point-or-greater markets violated Section 19(b)(1) of the Exchange Act. NSX's decision to limit enforcement of the MOE rule to 1/4-point-or-greater markets was not "reasonably and fairly implied" by the rule or any other existing rule of the Exchange. Therefore, NSX should have filed a proposed rule change with the Commission, and its failure to do so violated Section 19(b)(1) of the Exchange Act.

28. NSX further violated Exchange Act Section 19(b)(1) by failing to file a proposed rule change with the Commission in 2000 regarding its limitation of the MOE rule to 1/4-point-or-greater markets in light of the implementation of decimal pricing.

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<sup>24</sup> See Exchange Act Release No. 37046, 61 S.E.C. Docket 1577, 1996 WL 166535, at \*11 (Mar. 29, 1996).

### **Section 17(a)(1) of the Exchange Act and Rule 17a-1**

29. Section 17(a)(1) of the Exchange Act provides that every national securities exchange “shall make and keep for prescribed periods such records, furnish copies thereof, and make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title.” Pursuant to this authority, the Commission promulgated Rule 17a-1, which requires national securities exchanges to “keep and preserve at least one copy of all documents, including all correspondence, memoranda, papers, books, notices, accounts, and other such records as shall be made or received by it in the course of its business as such and in the conduct of its self-regulatory activity . . . for a period of not less than 5 years, the first two years in an easily accessible place.”

30. The foregoing record-keeping requirements extend to e-mail correspondence and other electronic records.<sup>25</sup> NSX’s failure to preserve electronic or paper copies of e-mail correspondence, or to retain electronic backups for the required five-year period, violated Section 17(a)(1) of the Exchange Act and Rule 17a-1 thereunder.

#### **E. Findings**

31. Based on the foregoing, the Commission finds that NSX, without reasonable justification or excuse, has failed to enforce compliance with the MOE and customer priority rules within the meaning of Section 19(h)(1) of the Exchange Act.<sup>26</sup>

32. Based on the foregoing, the Commission finds that NSX violated Sections 17(a), 19(b), and 19(g) of the Exchange Act and Rule 17a-1 thereunder.

33. Based on the foregoing, the Commission finds that Colker, without reasonable justification or excuse, has failed to enforce compliance with NSX’s MOE Rule within the meaning of Section 19(h)(4) of the Exchange Act.<sup>27</sup>

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<sup>25</sup> See *In the Matter of Robertson Stephens, Inc.*, Exchange Act Release No. 47144, 79 S.E.C. Docket 850, 2003 WL 431887, at \*9 (Jan. 9, 2003) (applying analogous Rule 17a-4 to broker-dealers); *In the Matter of Deutsche Bank Secs., Inc.*, Exchange Act Release No. 46937, 2002 WL 31687142, at \*3 (Dec. 3, 2002) (same); *Reporting Requirements for Broker or Dealers Under the Securities Exchange Act of 1934*, Exchange Act Release No. 38245, 63 S.E.C. Docket 1982, 1997 WL 46859, at \*5 (Feb. 5, 1997) (stating that “the content of the electronic communication is determinative” of whether such communication must be retained and made accessible).

<sup>26</sup> Section 19(h)(1) of the Exchange Act provides that the Commission is “authorized, by order, if in its opinion such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this [Act], . . . to censure or impose limitations upon the activities of [a] self-regulatory organization, if [the Commission] finds, on the record after notice and opportunity for hearing, that such self-regulatory organization has violated or is unable to comply with any provision of this [Act], the rules or regulations thereunder, or its own rules or without reasonable justification or excuse has failed to enforce compliance . . . (A) in the case of a national securities exchange, with any [provision of this Act, the rules or regulations thereunder, or the rules of such self-regulatory organization] by any member thereof or person associated with a member thereof. . . .”

## F. Undertakings

Respondent NSX has undertaken to:

1. Create a Regulatory Oversight Committee (“ROC”).

a. Within ninety (90) days of the issuance of this Order, NSX shall file proposed rule changes with the Commission in accordance with Section 19(b) of the Exchange Act and Rule 19b-4 to create a ROC to oversee all of NSX’s regulatory functions and responsibilities and to advise regularly the NSX’s Board of Trustees (“NSX Board”) about NSX’s regulatory matters. The ROC members shall not be, nor have been during the preceding three years, employees of NSX or any NSX member firm. The NSX Board shall appoint the members of the ROC. The ROC shall elect a Chairperson from among its members.

b. The responsibilities of the ROC shall include, but not be limited to: (i) oversight of NSX’s regulatory functions to enforce compliance with the federal securities laws and NSX rules, including monitoring the design, implementation, and effectiveness of NSX’s regulatory programs; (ii) recommending to the NSX Board an adequate operating budget for NSX’s regulatory functions; (iii) approving the promulgation, filing, or issuance of new rules, rule amendments, rule interpretations, and regulatory circulars; (iv) taking any other action necessary to fulfill its oversight and advisory responsibilities; and (v) adopting policies and procedures to ensure the independence of the Chief Regulatory Officer described in Section F.2.a. below.

c. The ROC shall be authorized to retain, at NSX’s expense, outside counsel and consultants as it deems appropriate to carry out its responsibilities.

d. The ROC shall create and maintain complete minutes of all of its meetings, and shall also create and maintain records reflecting the ROC’s recommendations or proposals made to NSX Board, and NSX Board’s decision as to each such recommendation or proposal.

e. In the event that the ROC’s recommended operating budget for NSX’s regulatory functions, as described in Section F.1.b. above, either: (i) is less than the previous year’s budget by a material amount, (ii) is rejected by the NSX Board, (iii) is reduced by the NSX Board by a material amount, or (iv) is altered by the NSX Board in a manner that, in the judgment of the ROC, materially impairs the ability of NSX to meet its regulatory obligations, then NSX shall, within fifteen (15) business days of such NSX Board action, notify the Director of the Commission’s Division of Market Regulation (“Market Regulation”) in writing, providing copies

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<sup>27</sup> Section 19(h)(4) of the Exchange Act provides that the Commission is “authorized, by order, if in its opinion such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this [Act], to remove from office or censure any officer or director of [a] self-regulatory organization, if [the Commission] finds, on the record after notice and opportunity for hearing, that such officer or director . . . without reasonable justification or excuse has failed to enforce compliance . . . (A) in the case of a national securities exchange, with any [provision of this Act, the rules or regulations thereunder, or the rules of such self-regulatory organization] by any member or person associated with a member . . . .”

of all minutes and other records reflecting the ROC's budget proposal and the NSX Board's decision regarding such proposal.

f. Subject to Commission approval of NSX's proposed rule changes, NSX shall fully implement this undertaking within one-hundred-eighty (180) days of the issuance of this Order.

2. Adopt structural protections, including the following, to ensure that NSX's regulatory functions shall be independent from the commercial interests of NSX and its members.

a. Effective immediately upon the issuance of this Order, NSX shall appoint an individual to serve in the exclusive capacity as a Chief Regulatory Officer ("CRO"), and who shall report directly to the NSX Board and the ROC (once it has been created). The CRO shall have primary executive responsibility for NSX's regulatory functions, including, but not limited to: (i) implementation of NSX's regulatory programs; (ii) formulation and implementation of NSX's regulatory budget; and (iii) administration of NSX's regulatory department and all NSX regulatory personnel matters (including hiring, performance review, promotion, compensation, and termination). The CRO shall have no responsibility for any non-regulatory functions at NSX, except that the CRO may also serve in the capacity of General Counsel ("GC") provided that such CRO/GC shall report only to the NSX Board and the ROC (once it has been created). Subject to any necessary NSX Board review or approval, the CRO, in conjunction with the ROC, shall make all final regulatory determinations on behalf of NSX.

b. The CRO shall provide the ROC with all information that the ROC may request to fulfill its responsibilities.

c. Effective immediately upon the issuance of this Order, NSX shall not permit its incumbent president and chief executive officer, or any successors to the positions of president or chief executive officer, to have any direct or indirect supervisory responsibility for: (i) the role or function of the ROC or the CRO; (ii) NSX's regulatory functions; (iii) the creation or implementation of the budget for NSX's regulatory functions; or (iv) NSX regulatory personnel matters. However, NSX's chief executive officer or president may advise the NSX Board regarding any aspect of NSX's operations, and, if a member of the NSX Board, may vote on all matters except for those described in (i) through (iv) above, and may also vote on the approval of the overall budget for the Exchange.

3. Propose and adopt internal procedures that provide for the ROC and the NSX Board to approve the issuance of regulatory circulars. Such procedures shall provide for ROC review and approval not later than thirty-five (35) days after the effective date of a regulatory circular.

4. Effective immediately upon the issuance of this Order, create and maintain complete and detailed minutes of all NSX Board meetings.

5. Implement and maintain, to the extent practicable, automated daily surveillance for potential violations of the following NSX and Exchange Act rules: Exchange Act

Rule 11Ac1-4 and NSX Rule 12.10, Interpretation and Policy .01 (Limit Order Display); NSX Rule 11.9(c)(iii) (Two-Sided Quotations); NSX Rule 11.9(u) and Interpretation and Policy .01 (Limit Order Protection); NSX Rule 12.6 (Customer Priority); NSX Rule 14.9(b) (Trade Throughs); and NSX Rule 14.9(d) (Locked/Crossed Markets). Such automated daily surveillance shall be deemed practicable with respect to the foregoing rules unless the CRO, with the approval of the ROC, has made a written submission to the Commission's Office of Compliance Inspections and Examinations ("OCIE"), with which OCIE concurs, demonstrating that such automated daily surveillance is infeasible with respect to a particular rule or rules, or that the costs of such surveillance outweigh the benefits, and that NSX can adequately conduct surveillance with respect to the particular rule or rules without such automated daily surveillance.

6. File, within sixty (60) days of the issuance of this Order, proposed rule changes with the Commission in accordance with Section 19(b) of the Exchange Act and Rule 19b-4 to require NSX designated dealers to implement system enhancements, to the extent practicable, such that when a dealer 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 dealer's side of the trade, the designated dealer's system will systemically allocate the execution to the customer order, unless the trade meets a specified exemption in NSX's rules. NSX shall also require that the system enhancements adopted in compliance with this undertaking cannot be disabled by NSX's designated dealers. Subject to Commission approval of NSX's proposed rule changes, NSX shall fully implement this undertaking within one-hundred-eighty (180) days of the issuance of this Order.

7. Design and implement a mandatory, regular training program for all members of NSX's regulatory department that addresses compliance with the federal securities laws and NSX rules.

8. Adopt examination procedures designed to ensure the adequacy of the training programs provided by NSX designated dealer firms for their employees in connection with their activities in trading on NSX.

9. Engage an independent consultant and require him/her to perform functions as follows.

a. Within ninety (90) days of the issuance of this Order, NSX shall engage an independent consultant (the "Consultant"), not unacceptable to the Commission, to conduct a comprehensive review of: (i) NSX's policies and procedures for rulemaking and the issuance of regulatory circulars; (ii) surveillance for potential violations of NSX's customer priority rule; (iii) NSX's examination program concerning its member firm's policies and procedures, and the implementation of such policies and procedures, for compliance with NSX and Exchange Act rules relating to trading; (iv) NSX's enforcement program with regard to: the handling of complaints; the initiation, conduct, and closing of inquiries and investigations; the institution of disciplinary proceedings; and the adequacy of sanctions; and (v) NSX's document retention policies and procedures. The Consultant shall assess whether the foregoing programs, policies, and procedures are reasonably designed and implemented to ensure compliance by NSX and its members with the applicable federal securities laws and NSX rules. The Consultant shall

make recommendations for the enhancement of NSX's regulatory programs as may be necessary in light of the Consultant's review and assessment.

b. NSX shall require the Consultant to submit a report of his/her findings and recommendations (the "Report") to the NSX Board within three (3) months of the Consultant's engagement. Within thirty (30) days of the receipt of the Report, the NSX Board shall adopt all recommendations made by the Consultant, subject to Section F.9.c. below, and the ROC shall take steps necessary to commence implementation of all such recommendations. NSX shall direct the Consultant to provide copies of the Report promptly to the respective Directors of Market Regulation and OCIE.

c. If the NSX Board determines that any of the Consultant's recommendations in the Report are unduly burdensome or impractical, it may propose an alternative reasonably designed to accomplish the same objectives, and shall submit any such alternative to the Consultant within forty-five (45) days of receipt of the Report. If, upon evaluating the NSX Board's proposal, the Consultant determines that the suggested alternative is reasonably designed to accomplish the same objectives as the recommendation(s) in question, then the Consultant shall approve the suggested alternative, amend his/her recommendation(s), reissue the Report within fifteen (15) days of receipt of the NSX Board's proposal, and the NSX Board shall adopt the Consultant's recommendation(s) within thirty (30) days of receipt of the amended Report. If the Consultant determines that the suggested alternative is not reasonably designed to accomplish the same objectives, the Consultant shall reject the NSX Board's proposal and the NSX Board shall adopt the Consultant's original recommendation(s) within thirty (30) days. In the event that the NSX Board and the Consultant are unable to agree on an alternative proposal, NSX and the Consultant shall, within fifteen (15) days of the Consultant's rejection of the NSX Board's proposal, jointly confer with Market Regulation and OCIE to resolve the matter.

d. Within nine (9) months of the NSX Board's receipt of the Consultant's Report, or receipt of the Consultant's amended Report if applicable under Section F.9.c. above, the CRO shall certify in writing to the respective Directors of Market Regulation and OCIE that, to the best of his/her knowledge based on reasonable inquiry: (i) all of the Consultant's recommendations adopted by the NSX Board have been implemented or, if the Consultant determines that any recommendation cannot be implemented within nine (9) months, will be implemented within the period specified by the Consultant; and (ii) NSX has complied fully with all of the undertakings in this Order.

e. NSX shall require the Consultant to enter into an agreement that provides that for the period of engagement and for a period of two (2) years from completion of the engagement, the Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with NSX, or any of its present or former, directors, officers, employees, or agents acting in their capacity as such. The agreement will also provide that the Consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the Consultant in performance of his/her duties under this Order shall not, without prior written consent of Market Regulation, enter into any employment, consultant, attorney-client, auditing or other professional relationship with NSX, or

any of its present or former directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two (2) years after the engagement.

10. Expend sufficient funds to permit the Consultant, the ROC, and NSX regulatory personnel to discharge all of their duties, including, but not limited to, providing adequate funds for the retention of outside counsel and/or professionals.

11. Beginning one (1) year after the date of the certification described in Section F.9.d. above, and each year thereafter for two (2) years (for a total of three (3) additional annual certifications), the CRO shall certify to the Director of Market Regulation that, to the best of his/her knowledge based on reasonable inquiry, NSX remains in compliance with all of the undertakings in this Order.

12. Retain a Third-Party Regulatory Auditor and require him/her to perform functions as follows.

a. One (1) year and three (3) years after NSX implements all of the Consultant's recommendations (for a total of two (2) audits), NSX shall retain a third-party regulatory auditor ("Regulatory Auditor"), not unacceptable to the Commission staff, to conduct an audit of NSX's surveillance, examination, investigation and disciplinary programs in order to assess: (i) whether NSX's policies and procedures, including but not limited to surveillance parameters, are reasonably designed and effective to ensure compliance with and to detect and deter violations of all federal securities laws and NSX rules relating to trading; and (ii) whether NSX is in compliance with: (a) the policies and procedures described in (i) above; (b) any outstanding recommendations relating to trading rules or surveillance for trading rule violations made by OCIE and Market Regulation; and (c) any undertakings contained in this Order.

b. The Regulatory Auditor must develop a written audit plan of sufficient scope and detail to achieve the audit objectives and to identify regulatory areas in need of special consideration. In performing the audit, the Regulatory Auditor and other qualified persons hired by the Regulatory Auditor ("qualified persons") shall have adequate knowledge and understanding of NSX's regulatory programs, policies and procedures. The Regulatory Auditor and the qualified persons shall exercise due professional care and independence in performing the audit. The Regulatory Auditor shall formulate conclusions based on sufficient, competent evidential matter that is obtained through, among other things: (i) inspection of documents, including written procedures, rules, and staff files; (ii) observation of trading processes and NSX's regulatory systems and practices; (iii) interviews of regulatory staff (including the CRO), the members of the ROC, NSX member firms and other relevant persons; and (iv) case studies and testing of various regulatory functions and trading practices. NSX shall cooperate fully with the Regulatory Auditor and qualified persons and provide the Auditor and qualified persons with access to its files, books, records, and staff as reasonably requested for the audit.

c. No later than forty-five (45) days after the audit is concluded, the Regulatory Auditor shall submit audit conclusions as to its assessment of the matters described in Section F.12.a. above to the NSX Board and to the Directors of Market Regulation and OCIE. The audit conclusions shall also be included in NSX's annual report on Form 1.

d. No later than forty-five (45) days after the audit is concluded, the Regulatory Auditor shall also submit to the NSX Board and to the Directors of Market Regulation and OCIE an audit report: (i) describing the purpose, scope, and nature of the audit; and (ii) identifying any significant deficiencies or weaknesses identified during the audit.

e. Any finding of a deficiency or weakness shall require a review by the ROC of the relevant regulatory program, policy, or procedure within ninety (90) days of the date of the audit report.

f. NSX shall bear the full expense of the audits. Within forty-five (45) days after issuance of this Order, NSX shall set aside a reserve fund of \$1 million for the establishment, retention, and payment of the Regulatory Auditor with respect to the audits required by this Order. If the expenses for the audits exceed the funds in the reserve fund, NSX shall use additional funds to pay the costs of the audits. If any funds remain after the audit period, those funds shall be used solely for such regulatory matters as may be directed by the ROC.

g. The Regulatory Auditor shall provide the Commission staff with any documents or other information that the Commission staff requests regarding the Regulatory Auditor's work pursuant to this undertaking. NSX shall not assert, and shall require the Regulatory Auditor to agree not to assert, privilege or work product claims in response to any of the Commission staff's requests.

#### 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 Respondent's Offer.

Accordingly, it is hereby ORDERED that:

A. Respondent NSX be, and hereby is, censured pursuant to Section 19(h)(1) of the Exchange Act;

B. Respondent NSX be, and hereby is, ordered pursuant to Section 21C of the Exchange Act, to cease and desist from committing or causing any violations and any future violations of Sections 17(a), 19(b), and 19(g) of the Exchange Act and Rule 17a-1 thereunder;

C. Respondent NSX shall comply with the undertakings enumerated in Section F. above; and

D. Respondent Colker be, and hereby is, censured pursuant to Section 19(h)(4) of the Exchange Act.

By the Commission.

Jonathan G. Katz  
Secretary