

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 55507 / March 22, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12594

In the Matter of

American Stock Exchange LLC,

Respondent.

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

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 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 the American Stock Exchange LLC (“Amex” or “Respondent”).

II.

In anticipation of the institution of these proceedings, the Amex has submitted an Offer of Settlement (“Offer”), which 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 the Amex and the subject matter of these proceedings, which are admitted, the Amex consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions, a Censure, and a Cease-and-Desist Order Pursuant to Sections 19(h)(1) and 21C of the Securities Exchange Act of 1934 (“Order”), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

A. SUMMARY

This matter involves the failure by the Amex adequately to enforce certain order handling rules and to comply with its record keeping obligations. From at least 1999 through June 2004, the Amex had critical deficiencies in its surveillance, investigative, and enforcement programs for assuring compliance with its rules as well as the federal securities laws. The Amex did not conduct adequate surveillance for certain types of violations by its specialists and floor brokers. This was primarily because the Amex's surveillance programs were inadequate to detect such violations. When the surveillance programs detected possible order handling rule violations, the Amex did not adequately review the surveillance reports, investigate the potential violations reflected in those reports, or did not complete certain investigations in a timely manner. When the Amex did detect violations, it sometimes failed to make referrals for disciplinary action or improperly excused the conduct.

The Amex's continual regulatory deficiencies during this time period resulted in large part from its failures to pay adequate attention to regulation, to put in place an oversight structure, or to dedicate sufficient resources to ensure that the exchange was meeting its regulatory obligations. These failures were particularly significant with respect to the options market because the Amex was under a Commission order to improve its surveillance and enforcement of the options order handling rules. As a result of its failure adequately to surveil for and investigate violations of, and to enforce, certain options order handling rules, the Amex violated Section 19(g) of the Exchange Act. In addition, the Amex failed to furnish accurate records and, as a result, violated Section 17(a)(1) of the Exchange Act and Exchange Act Rule 17a-1.

In December 2004, the Amex was sold to its members, and in 2005, prior senior management was replaced. All of the conduct at issue occurred under prior senior management.

B. RESPONDENT

American Stock Exchange LLC, located in New York, New York, is a national securities exchange registered with the Commission pursuant to Section 6 of the Exchange Act. From 1998 until December 31, 2004, the Amex was a subsidiary of the National Association of Securities Dealers, Inc. ("NASD"). On December 31, 2004, the NASD completed the sale of its interest in the Amex and transferred control to the Amex Membership Corporation. New management has

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

assumed senior executive positions at the Amex, including the Chairman/Chief Executive Officer. The Amex trades over 800 stocks, various types of options, and over 100 exchange-traded funds.

C. FACTS

1. Prior Commission Action

From at least 1999, the Amex was on notice that its surveillance, investigatory, and enforcement programs were inadequate. On September 11, 2000, the Commission issued an order (“September 2000 Order”), to which the Amex consented, finding, in relevant part, that the Amex had failed effectively to enforce compliance by its members with exchange rules, policies, or procedures relating to options order handling.² Specifically, the Commission found that the Amex had failed to surveil for, or to take appropriate action with respect to evidence of, violations of firm quote,³ customer priority,⁴ limit order display,⁵ and trade reporting rules⁶. These rules were designed to protect investors and provide some of the primary safeguards against execution abuses by specialists.

² See In the Matter of Certain Activities of Options Exchanges, Exchange Act Rel. No. 43268 (Sept. 11, 2000). The Commission issued its order against the Amex and three other options exchanges.

³ The firm quote rule generally requires options specialists to trade options at the prices and in the amounts that they quote. During most of the period relevant to this Order, the firm quote rule for options was set forth in Exchange Act Rule 11Ac1-1, which had a compliance date of April 2001, and Amex Rule 958A. With the Commission’s adoption of Regulation NMS in August 2005, the Commission’s firm quote rule was redesignated as Exchange Act Rule 602. Under Exchange Act Rule 602, its predecessor Exchange Act Rule 11Ac1-1, and Amex Rule 958A, responsible brokers or dealers are required, with a few exceptions, to execute options transactions with customers at prices at least as favorable as their published bids or offers at the time the orders are presented and in any amount of contracts up to their published sizes.

⁴ With certain exceptions, the priority rules generally require that a customer limit order be executed prior to the execution of any other order if it has the best price, i.e., the highest bid or lowest offer. See Amex Rules 126 and 950(d). If there is more than one customer order at the best price, the customer order that arrives first has priority.

⁵ The obligation to display limit orders generally requires that a customer limit order that is priced better than the highest bid or the lowest ask price currently quoted on the exchange immediately be displayed in the quotations. As discussed infra at III.C.2.c., at the time of the September 2000 Order, specialists were required to display such limit orders as part of their due diligence obligations. In January 2005, the Commission approved, and the Amex thereafter implemented, a limit order display rule specifically applicable to options.

⁶ The trade reporting rule generally requires that transactions be reported within a specified time after execution. The Amex’s trade reporting rule, adopted in August 2000, requires that options transactions are to be reported to the Amex Options Market Data System within 90 seconds of execution and that transactions not reported within that time are to be designated as late. See Amex Rule 992.

The Commission ordered the Amex to enhance and improve its regulatory programs for surveillance, investigation, and enforcement of the options order handling rules, including compliance with the limit order display, priority, trade reporting, and firm quote rules. The Amex further was required to provide Commission staff with annual affirmations detailing its progress in complying with the September 2000 Order. The Amex failed to comply with these obligations.

2. Inadequate Surveillance, Investigatory, and Enforcement Programs for Options Trading

Notwithstanding the September 2000 Order, as late as 2003, there remained significant deficiencies in the Amex's surveillance, investigatory, and disciplinary programs regarding the firm quote, customer priority, trade reporting, limit order display, as well as, other options order handling rules. During the relevant time, the Amex's Derivatives Trading Analysis Department ("DTA") was primarily responsible for the Amex's regulatory surveillance program for the derivatives and options markets. In January 2002, the Amex formed the Best Execution Department ("Best Ex") within the DTA specifically to conduct surveillance reviews and investigations into whether Amex members complied with options order handling rules. Best Ex was responsible for reviewing surveillance reports for violations of the firm quote, trading ahead, trade reporting, and stopped order rules, as well as, the limit order display obligation.

When Best Ex was formed, the Amex contemplated that the department would have five individuals to carry out its functions. During the relevant time, however, Best Ex never had a staff of five. It initially had a staff of four and thereafter had four or fewer individuals. The lack of staff in Best Ex was a significant contributing factor to the Amex's inadequate surveillance, investigative, and enforcement programs for options order handling rules.

a. The Firm Quote Rule

The firm quote rule is one of the primary means of ensuring that investors receive the best price available for their orders. Notwithstanding the importance of the rule, there were multiple deficiencies in the Amex's surveillance, investigatory, and enforcement programs related the rule. The Amex improperly applied the rule, established unreasonable surveillance parameters, and failed adequately to pursue disciplinary actions for violations of the rule.

The firm quote rule, in part, requires a responsible broker or dealer⁷ to stand by the quoted price up to the full quoted size for each option series.⁸ As such, when a responsible broker or

⁷ A responsible broker or dealer is a member of an exchange who communicates quotes to other members of the exchange. See Exchange Act Rule 602(b)(65). The responsible broker or dealer frequently is the specialist for the subject security.

⁸ Options of the same class that have the same exercise price and expiration date are an option series.

dealer receives several executable orders in different series simultaneously, the responsible broker or dealer must fill orders up to the quoted size at the quoted price for each option series. The Amex, however, improperly applied the rule and permitted a responsible broker or dealer to back away from the quote in every option series within a class after executing an order of any size in any series within the class.

The Amex also employed incorrect parameters in reviewing exception reports to determine whether there was an applicable exception to the firm quote rule.⁹ For example, when it initially began reviewing these reports, the Amex simply concluded without investigation that if the quote changed in the thirty seconds following receipt of an order, the specialist was in the process of changing the quote when he or she received the order. The thirty-second period was an unreasonably long period to use in this analysis, because it permitted the precise type of conduct that the firm quote rule was designed to prohibit. Specifically, within thirty seconds, a specialist could receive an order, revise the quote to an inferior price, and either not execute the order or execute it at an inferior price without being cited for a violation of the firm quote rule.

Shortly after it began using the thirty-second review parameter, the Amex expanded the time frame to seventy seconds. The Amex took this action because of the possibility that there could be a delay of up to forty seconds between the time when an order entered the Amex's electronic systems and the time when the order was displayed on the specialist's order book. The seventy-second period, however, afforded specialists even more time to revise quotes and then either not execute orders or execute them at inferior prices without the risk of review of their conduct and possible disciplinary action.

The Amex also excused violations of the firm quote rule based on rationales not recognized under any exception to the rule. For example, the Amex improperly excused violations when a customer limit order was executed at the limit price rather than at an Amex quote that represented a better price. It also excused violations when a specialist paired off a customer's order with another customer order even though, at the time, there was a posted quote at a better price. Excusing violations of the firm quote rule based on non-existent exceptions potentially deprived investors of the execution prices to which they were entitled.

In addition to incorrectly applying the firm quote rule and using unreasonable surveillance parameters, the Amex failed to investigate conduct that its surveillance reports identified as potential rule violations. One surveillance report that the Amex used to identify

⁹ A responsible broker or dealer is excused from the firm quote obligation if (1) prior to the presentation of the order, a revised quote was communicated to the Exchange, (2) at the time of presentation of the order, a transaction is in the process of being effected and a revised quote is communicated to the Exchange immediately thereafter, or (3) the Exchange is experiencing "unusual market conditions" such that it is "incapable of collecting, processing, and making available to quotation vendors" quotation data that accurately reflect the state of the market on the Exchange. See Exchange Act Rule 602(a)(3)(i), (b)(3)(i); former Exchange Act Rule 11Ac1-1(b)(3)(i), (c)(3)(i); Amex Rule 958A(c), (d).

potential violations of the rule was the “Executable Orders Unexecuted” report. The report was generated on a daily basis and captured instances in which an Amex specialist failed to execute a market or limit order after the order became executable. As such, all orders captured on the report represented potential violations of the rule. The Amex, however, did not review all of the orders that appeared on the report. In certain instances, for example, the Amex reviewed only those orders that were unexecuted for more than two minutes. This practice was adopted in part due to the extraordinarily limited resources of Best Ex. By December 2002, Best Ex was so backlogged in its review that it was only reviewing orders from August 2002. By March 2003, Best Ex had slightly decreased the backlog, but was still over two months behind in its review. The delay in reviewing the Executable Orders Unexecuted report impeded further investigation of potential violations and their ultimate referral for disciplinary action, because of the difficulty the specialist and other witnesses had recalling the details of an order placed months in the past.

When it made referrals, the DTA referred almost all potential violations to its Minor Floor Violation Disciplinary Committee (“MFV Disciplinary Committee”). The delay in making the referrals to the MFV Disciplinary Committee further impeded disciplinary actions because the committee’s evaluation of the conduct also depended on the memory of the specialist. After the committee complained about the delay, the DTA, in August 2002, stopped referring potential violations of the firm quote rule to the MFV Disciplinary Committee.

Even when the MFV Disciplinary Committee considered referrals, it improperly applied the firm quote rule. In some instances, committee members did not understand what were valid exceptions to the rule and in other instances, committee members excused conduct based on improper analysis. For example, in determining whether a violation had occurred, committee members considered the prior disciplinary history of the specialist, whether the violation was intentional, and whether the specialist was busy. None of these factors represents a valid exception, and the MFV Disciplinary Committee’s reliance on these factors contributed to the Amex’s failure to enforce the firm quote rule.

b. Trading Ahead

The Amex’s trading ahead rules require a specialist to give precedence to an order entrusted to him or her as agent before executing at the same price any transaction in the same option for an account in which the specialist has an interest.¹⁰ To monitor for violations of these rules, the Amex created the “Trading Ahead Report.” There were, however, significant deficiencies in the parameters of the Trading Ahead Report and also in the Amex’s review of the report.

¹⁰ See Amex Rules 155 and 950(a). The Amex also had a rule that required a registered options trader, when establishing or increasing a position for an account in which he or she had an interest, to give precedence to off-floor orders. See Amex Rule 111(d). A registered options trader is a participant on the exchange trading for his or her own or firm’s account who is responsible for making two-sided markets.

The Trading Ahead Report captured only those potential trading ahead violations in which a specialist's execution occurred at least sixty seconds after receipt of the customer's order. This parameter essentially gave the specialist a sixty-second grace period to trade ahead of a customer's order and thereby receive a better price than the customer then received. There is no justification for permitting a specialist to trade ahead of a customer's order within sixty seconds of receipt of the order. The Trading Ahead Report also did not capture instances in which a specialist traded ahead for his or her own account at the same price as a customer order held on the specialist's book. This conduct, which deprives the customer of the opportunity to receive a timely execution, is also prohibited by the Amex's rules.

With respect to the review and analysis of the information on the Trading Ahead Report, the Amex again did not review all instances of potential trading ahead violations identified on the report. It instead reviewed only selected instances of potential violations. In several instances, the Amex excused what appear to be clear violations, such as when a specialist traded for his or her account at a better price than the specialist's customer received.¹¹ Accordingly, the Amex's surveillance, investigatory, and enforcement programs related to violations of the trading ahead rules were deficient.

c. Limit Order Display

Pursuant to its rules, the Amex required specialists to exercise due diligence in handling customer orders.¹² As part of their due diligence obligations, specialists immediately were to display customer limit orders that improved Amex quotes.¹³ The immediate display of such orders is an important means of enabling investors to receive the best executions for their orders. However, the Amex's surveillance, investigative, and enforcement programs relating to the limit order display obligation were deficient.

Following issuance of the September 2000 Order, the Amex developed the "Limit Order Display" report which was supposed to capture instances in which a specialist failed immediately to display a customer order that improved the Amex quote. The Amex, however, inappropriately

¹¹ The Amex rules do allow a specialist or registered options or equity trader to trade ahead of a customer order in limited circumstances, such as when the registered trader is closing a position. These exceptions do not appear to have been a factor in the analysts' review of the Trading Ahead Report.

¹² See Amex Rules 156 and 950(g).

¹³ In January 2005, the Commission approved, and the Amex thereafter implemented, a limit order display rule that was specifically applicable to options. See Self-Regulatory Organizations; Order Approving a Proposed Rule Change and Amendments No. 1, 2, 3, 4, 5, and 6 Thereto, and Notice of Filing and Order Granting Accelerated Approval to Amendments No. 7 and 8 Thereto by the American Stock Exchange LLC to Require the Immediate Display of Customer Options Limit Orders, Exchange Act Rel. No. 51062 (Jan. 21, 2005). The role of a limit order display rule is described generally supra at note 5.

limited its surveillance to the conduct of specialist units.¹⁴ By limiting its surveillance in this manner, however, the Amex overlooked misconduct by individual specialists. This was an unreasonable practice because it is the individual specialist who is responsible for displaying limit orders, and specialists not infrequently change firms. Limiting its surveillance to the conduct of specialist units also meant that the Amex was unable to detect patterns of limit order display violations in options classes.

Even to the extent that it did surveil for violations of the limit order display obligation, the Amex employed a flawed method of determining compliance rates. The Amex measured compliance by calculating the orders not displayed as a percentage of all marketable orders received by the specialist unit.¹⁵ Marketable orders, however, do not improve published quotes and, accordingly, are not subject to the display requirement. As a result, the Amex's calculation of compliance rates was inflated.

d. Trade Reporting

The trade reporting rule requires that transactions be reported within a specified time after execution.¹⁶ Reliable trade reporting enhances the transparency of the markets and effective surveillance and enforcement with respect to order handling and other rules. Similar to its surveillance relating to the limit order display obligation, the Amex inappropriately limited its review of potential violations of the trade reporting rule to instances in which a specialist unit reported more than five percent of its trades late. In determining whether the five-percent threshold was exceeded, trades that were automatically reported were included, rather than just trades that were not reported automatically. This practice gave the appearance of a higher compliance rate than was warranted.¹⁷

Separately, the Amex did not monitor for compliance by option class and thus was unable to determine whether there were patterns of late trade reporting in particular options classes. The Amex further did not surveil for transactions that were reported late but that were not designated as such when the transactions were reported.¹⁸ As a result of these deficiencies, the Amex

¹⁴ A specialist unit is comprised of several individual specialists employed by a specialist firm.

¹⁵ A marketable order is an order that is executable immediately either because it is an order to buy or sell at the current market price or because it is a limit order that is executable at the currently published quote, i.e. a buy limit order priced at or higher than the published offer or a sell limit order priced at or below the published bid. Market orders, marketable limit orders, and certain other orders were not subject to the display requirement.

¹⁶ See supra note 6.

¹⁷ At the relevant time, the Amex estimated that approximately sixty percent to seventy percent of options transactions were electronically routed and executed orders that were reported immediately.

¹⁸ Pursuant to Amex Rule 992(b), a transaction not reported within ninety seconds of execution was to be

inadequately surveilled for and investigated violations of, and enforced, the trade reporting rule.

e. Busted and Adjusted Trades

The improper cancellation of trades can be a means by which specialists or other market participants avoid their firm quote and other regulatory obligations. Amex Rule 135, in effect for options during the period in question, prohibited exchange members from busting or adjusting a trade unless the transaction was made in error or the bust or adjust was made for other proper reasons. The rule further required both parties to the trade to agree to the bust or adjust. Amex Rule 22 additionally requires that there be a written record of all floor official rulings on busting or adjusting trades and that, at the end of each day, the ruling records be submitted to the exchange.

Continuing at least through 2004, the Amex allowed trades to be busted and adjusted without necessarily obtaining the approval of both parties to the transactions. The Amex's records, moreover, had no clear indication whether floor officials had approved busted or adjusted trades or whether the parties to the transactions had agreed to the bust or adjust.¹⁹ Without this information, the Amex could not assess whether violations of the relevant rules had occurred. Accordingly, the Amex failed to surveil for violations of, and enforce, its rules for busting or adjusting trades.

f. Stopped Orders

The Amex's "stopped order" rule essentially requires a specialist to provide execution assurances under certain circumstances.²⁰ An exchange member who wants to buy or sell an option at a better price than the price currently available can ask the specialist to "stop" the member's order and to attempt to obtain a better price. If the specialist agrees, the specialist then is obligated to execute the member's order at a better price or, if one cannot be obtained, at the market price at the time of the stop. The Amex developed a "Stopping Orders Report" that captured orders that specialists stopped at the Amex quote or at prices inferior to the Amex quote. The Amex was to review the report for instances in which a stopped order was executed at a price below the Amex quote at the time of the stop.²¹ As with other surveillance reports, the Amex did not review all potential violations reflected on the Stopping Orders Report but only selected transactions. In addition, instances in which specialists executed stopped orders at prices that were

designated as late. When that occurred, the specialist was supposed to add to the trade report a modifier designating the trade as late.

¹⁹ The lack of documentation also is a violation of the Amex's record keeping obligations, which are discussed infra.

²⁰ See Amex Rules 109, 154, and 950(f), (o).

²¹ The execution of an order at a price inferior to the Amex quote at the time of the stop order also may constitute a violation of the firm quote rule.

worse than the market prices at the time of the stop were excused. The Amex thus unreasonably failed to surveil for and investigate violations of, and to enforce, the stopped order rule.

3. Inadequate Surveillance for Equity Trading and Floor Brokers

The Amex also failed adequately to surveil for compliance with certain equity trading rules by its specialists. For example, from at least January 2003 until June 2004, the Amex did not conduct any surveillance for limit order display rule compliance for equities. During that same time, the Amex failed to generate its trading ahead surveillance reports for approximately seven months. Furthermore, the Amex's surveillance with respect to firm quote violations used inappropriate review parameters which excluded categories of potential violations. Specifically, to determine whether there were potential violations of the firm quote rule, the Amex inappropriately looked at the quote in effect at an order's time of execution rather than the earlier time when the order was presented to the specialist. The majority of the Amex's other equity trading surveillances had similar deficiencies in that they were not done, were conducted only sporadically, or had parameters that did not result in sufficient surveillance.

Surveillance for floor broker trading were also inadequate. Several of the floor broker surveillances, including surveillance for frontrunning,²² either were not conducted at all or were conducted sporadically.

4. Failure to Make, Keep, and Furnish Complete and Accurate Records

The Amex also failed to make and keep certain of the required records relating to its surveillance, investigatory, and enforcement activities and further furnished the Commission with inaccurate documents.

a. Inadequate Documentation

(i) Options

The Amex lacked documentation sufficient to support its options surveillance, investigatory, and enforcement activities. The Amex, for example, failed uniformly to maintain in its case files the surveillance reports that gave rise to investigations, lacked audit trail data to support the potential applicability of exceptions to the firm quote rule, failed to maintain analyses and supporting documentation related to reviews of the Trading Ahead and Stopping Orders Reports, and failed to make or keep records of floor official approval and customer consent to busted and adjusted trades. Not only were Amex investigative files incomplete, but in an internal

²² Frontrunning involves a trader taking a position in a security to profit from advance, nonpublic knowledge of an imminent order that may affect the market price of that security. See Amex Rules 111, commentary .03(c) and 950(c).

review in 2003, the Amex was unable to locate many investigative files. In some instances, documents in case files were dated after the Amex's case tracking log reflected that the matters had been closed. In other instances, case files lacked documentation of how the matters were resolved, but logs reflected that the matters had been referred to the MFV Disciplinary Committee.

Documentation related to enforcement actions taken by the MFV Disciplinary Committee was also inadequate. The minutes of the meetings of the committee were vague and conclusory and did not provide sufficient information to evaluate the committee's actions. The minutes, for example, included records of the committee's decisions, but did not contain a discussion of the rationales for those decisions. Some of the minutes, moreover, failed even to include references to the types of violations that the committee considered. Other minutes were unclear as to which violations the committee considered or on which the violations the committee acted. In other instances, the minutes did not include a discussion of some matters that purportedly were on the agenda for those meeting.

(ii) Equities and Floor Brokers

The Amex similarly failed to maintain complete and accurate documentation regarding its equity and floor broker regulatory programs. For example, documentation relating to several surveillances in these areas was missing. For some surveillances, due to deficiencies in technology, the Amex maintained inaccurate data and was unable to electronically generate accurate surveillance logs. A lack of qualified individuals and insufficient supervision of those individuals also contributed to the Amex's failure to make and keep accurate records of its surveillances. All these deficiencies contributed to the Amex's failure adequately to surveil for violations by equity specialists and floor brokers.

b. The Failure to Furnish Timely, Complete, and Accurate Affirmations

The Amex furnished affirmations required by the September 2000 Order that were late, inaccurate, and incomplete. Affirmations detailing the Amex's compliance with the September 2000 Order were due annually on September 11. Without notice or a request for an extension of time, the Amex submitted the first affirmation (for 2001) almost five months late, on January 31, 2002, and the second affirmation (for 2002) again almost five months late, on February 7, 2003.

The first affirmation included the following representations:

- (1) the Amex's Enforcement Department was reviewing all matters that the DTA was proposing to submit to the MFV Disciplinary Committee before they were presented to the MFV Disciplinary Committee;
- (2) firm quote violations "will be forwarded to the Enforcement Department for their review and action unless there are extenuating circumstances";

- (3) in early September 2001, a Trading Ahead of Customer Orders Report and an Executable Orders Unexecuted Report had been incorporated into the Amex's routine surveillance;
- (4) the Amex was utilizing the following surveillance reports: (a) Lack of Traders Trading in Between the Markets and (b) Specialists Routinely Being the Only Contra-Side on a Trade;
- (5) the Amex had incorporated a Trade Reporting Report into its routine surveillance program; and
- (6) a Floor Broker Order Handling Summary Report had been incorporated into the Amex's routine surveillance.

None of these representations was accurate. At the time of the Amex's first affirmation, the Enforcement Department was not reviewing all matters that the DTA was proposing to submit to the MFV Disciplinary Committee, nor did the Enforcement Department ever review routinely all matters that the DTA was proposing to submit to the MFV Disciplinary Committee. The DTA also was not forwarding routinely firm quote violations to the Enforcement Department, nor did the DTA ever forward routinely firm quote violations to the Enforcement Department. Instead, the DTA referred most firm quote violations to the MFV Disciplinary Committee. In addition, the Trading Ahead of Customer Orders Report and the Executable Orders Unexecuted report were still in testing in September 2001 and were not actually implemented until approximately January 2002. Similarly, the reports for the Lack of Traders Trading in Between the Markets and for Specialists Routinely Being the Only Contra-Side on a Trade were also still in development at the time of the affirmation. Indeed, after March 2002, work on these reports ceased. Neither report was used for surveillance. In addition, requirements for the Trade Reporting Report did not start to be developed until February 2002, and a Floor Broker Order Handling Summary Report was never developed.

In its second affirmation, the Amex referenced the first affirmation, stating "[a]s reported in the Exchange's previous affirmation, during the first year following the issuance of the Commission's order, the Exchange implemented a significant number of initiatives . . .", but the second affirmation failed to correct the inaccuracies in the first affirmation. The second affirmation itself was less than three pages in length. It was conclusory in nature and provided little detail of improvements to the Amex's regulatory program.

D. DISCUSSION

As a self-regulatory organization, an exchange such as the Amex is a quasi-governmental body that has a responsibility that is fundamental to the enforcement of the federal securities laws.²³ It must have the capacity to comply, and to enforce compliance by its members, with the Exchange Act, the rules and regulations thereunder, and the exchange's own rules.²⁴ When an exchange fails to comply or to enforce compliance with these provisions, the Commission may take actions that it deems appropriate. The Amex violated provisions of the Exchange Act and Exchange Act rules and failed to enforce compliance by its members.

The Amex's regulatory deficiencies resulted in large part from its failures to pay adequate attention to regulation, to put in place an oversight structure, or to dedicate sufficient resources to ensure that the exchange was meeting its regulatory obligations. These failures were particularly significant with respect to the options market because the exchange was subject to the September 2000 Order.

1. Violation of Section 19(g)(1) of the Exchange Act

Section 19(g)(1) of the Exchange Act obligates the Amex as a self-regulatory organization to comply with the Exchange Act, the Exchange Act rules and regulations, and the Amex's rules. Section 19(g)(1) further obligates the Amex, absent reasonable justification or excuse, to enforce compliance with these provisions by its members and persons associated with those members. In carrying out its duty to enforce compliance, the Amex was required to develop and maintain surveillance over its members and to "be vigilant in surveilling for, evaluating, and effectively addressing issues that could involve violations" of the securities laws.²⁵ The conduct described above reflects a significant failure by the Amex to surveil for and investigate violations of, and to enforce compliance with, options and equities trading rules by Amex members. Particularly in light of the Amex's undertaking in the September 2000 Order to enhance and improve its surveillance, investigative, and enforcement processes with respect to the option order handling rules, there is no reasonable justification or excuse for the Amex's conduct. Under these circumstances, the Amex violated Section 19(g)(1) of the Exchange Act.

2. Violation of Section 17(a)(1) of the Exchange Act and Exchange Act Rule 17a-1

Section 17(a)(1) of the Exchange Act requires an exchange such as the Amex to make and keep for prescribed periods, and then to furnish the Commission with a copy of, such records as the Commission prescribes as necessary or appropriate in the public interest, for the protection of investors, or for other purposes set forth in the Exchange Act. Exchange Act Rule 17a-1(a) further

²³ See Regulation of Exchanges and Alternative Trading Systems, Exchange Act Rel. No. 40760, at 63 (Dec. 8, 1998).

²⁴ See Exchange Act § 6(b), 15 U.S.C. § 78f(b).

²⁵ National Ass'n of Sec. Dealers, Inc., Exchange Act Rel. No. 37538, at 3 (Aug. 8, 1996).

requires an exchange to keep and preserve at least one copy of all correspondence, records, and other documents made or received by it in its business and in the conduct of its self-regulatory activity. Rule 17a-1(c) requires an exchange promptly to furnish the Commission with a copy of any such document that the Commission requests. The requirement that an exchange keep and furnish records to the Commission includes the requirement that any accompanying explanation of those records be complete and accurate and that those materials be furnished on a timely basis.

The preparation, maintenance, and furnishing of complete and accurate records are essential to the proper functioning of an exchange as a self-regulatory organization. As described above, the Amex failed to keep and furnish records with respect to its surveillance and investigatory functions as well as its enforcement activities. By submitting the affirmations late and with inaccuracies, the Amex further failed to satisfy its obligation promptly to furnish the Commission with such documents as it requests.²⁶ Under these circumstances, the Amex violated Section 17(a)(1) of the Exchange Act and Exchange Act Rule 17a-1.

E. SUBSEQUENT DEVELOPMENTS RELATING TO THE AMEX

In determining to accept the Offer, the Commission has considered the remedial actions that the Amex has taken, including the Amex's agreement to comply with the undertakings described in Section III.F. below and the replacement of senior management responsible for regulatory compliance during the period in which the violations discussed herein occurred.

F. UNDERTAKINGS

The Amex has agreed to comply with the following undertakings:

1. The Amex shall, within 60 days after issuance of the Order, file with the Commission a proposed rule change that complies with Section 19(b) of the Exchange Act to identify and implement enhancements, to the extent practicable, to its trading systems for equities and options reasonably designed to prevent specialists from violating the Amex's priority rules, such that when a specialist is in the process of executing a specialist's 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 Amex system will systemically prevent the reporting of the execution and enable the specialist to allocate the appropriate portion of the specialist's trade to the customer order, unless the trade meets a specified exemption in the Amex's rules. Inappropriate use of any such exemption shall be subject to surveillance by the Amex. The Amex shall also require that the system enhancements adopted in compliance with this undertaking may not be disabled by the specialists. The

²⁶ The affirmations, which were required by the September 2000 Order, were prepared in the course of the Amex's activity as a self-regulatory organization and are records within the meaning of Section 17(a) of the Exchange Act and Exchange Act Rule 17a-1.

Amex shall fully implement this undertaking within 180 days of the date of this Order, subject to Commission approval of the relevant proposed rule changes.

2. The Amex shall, within 90 days after issuance of the Order, enhance its existing training programs as necessary to implement a mandatory annual training program for all Floor Members and members of the Amex's regulatory staff responsible for surveillance, investigation, examination, and discipline of Floor Members that addresses compliance with the federal securities laws and the Amex's rules in place to prevent and deter unlawful trading by Floor Members.
3. The Amex shall
 - (a) Commencing in 2007, and for each of the successive two-year periods thereafter (for a total of three two-year periods), retain a Third Party Auditor ("Auditor"), not unacceptable to the Commission staff, to conduct a comprehensive audit of the Amex's surveillance, examination, investigation and disciplinary programs relating to trading applicable to all Floor Members in order to achieve the following audit objectives:
 - (i) to determine whether the Amex's policies and procedures are reasonably designed and effective to ensure compliance with, and to detect and deter violations of, the federal securities laws and the Amex's rules relating to trading; and
 - (ii) to determine whether the Amex is in compliance with (1) the policies and procedures identified in section III.F.3(a)(i), above; (2) any outstanding commitments made by the Amex in relation to the written recommendations made by the Commission's Office of Compliance Inspections and Examinations ("OCIE") or the Division of Market Regulation relating to compliance with trading rules or surveillance for trading rule violations; and (3) any undertakings contained in this Order or section IV.B.f. of the September 2000 Order.
 - (b) Require the Auditor and other qualified persons hired by the Auditor ("qualified persons") to have or acquire within a reasonable period of time adequate knowledge and understanding of the Amex's regulatory programs, policies and procedures and to possess sufficient competence and resources necessary to assess the Amex's surveillance, examination, investigation, and disciplinary programs.
 - (c) Require the Auditor to develop a written audit plan of sufficient scope and detail to achieve the audit objectives described in section III.F.3(a) above and to identify regulatory areas in need of special consideration. The Amex

further shall require that, in performing the audit, the Auditor and the qualified persons shall exercise due professional care and independence.

- (d) Require the Auditor to formulate an opinion 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 the Amex's regulatory systems and practices; (iii) interviews of regulatory staff, floor members, and other relevant persons; and (iv) case studies and testing of various regulatory functions and trading practices.
- (e) Cooperate fully with the 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.
- (f) Require that each audit be concluded within 180 days of the field work. No later than 45 days after each audit is concluded, the Amex shall require the Auditor to submit an audit opinion as to its assessment of the Amex's surveillance, examination, investigation, and disciplinary programs to the Amex's Board of Governors and to the following officials at the Commission (the "Commission Officials"): (i) the Director of OCIE; and (ii) the Director of the Division of Market Regulation. The audit opinion shall also be included in the Amex's annual report.
- (g) No later than 45 days after each audit is concluded, require the Auditor also to submit an audit report to the Amex's Board of Governors and to the Commission Officials (i) describing the purpose, scope and nature of the audit; and (ii) identifying any significant deficiencies or weaknesses in the Amex's policies and procedures, or the Amex's compliance with these policies and procedures, OCIE recommendations, and the undertakings described in section III.F.1., 2, and 3.(a), above.
- (h) No later than 90 days after the date of the audit report, review all significant deficiencies or weaknesses identified in the audit report and develop a written plan of corrective actions to address each deficiency or weakness, including a date by which each corrective action shall be implemented. The Amex shall maintain a copy of such plan for the entire period of this undertaking and shall provide the plan to the Commission staff upon request.
- (i) Bear the full expense of each audit. Within 45 days after issuance of this Order, the Amex shall set aside a reserve fund of \$3 million (\$1 million per audit) for the establishment, retention and payment of the Auditor for the three audits. If the expenses for the audits exceed the funds in the reserve

fund, the Amex shall use additional funds to pay the costs of the audits. If any funds remain after completion of the three audits described in section III.F.3.(a) above, those funds shall be used for future audits that the Commission may direct.

- (j) Require the Auditor to provide the Commission staff with any documents or other information the Commission requests regarding the Auditor's work pursuant to this undertaking. The Amex shall not assert, and shall require the Auditor to agree not to assert, privilege or work product claims in response to any of the Commission staff's requests.
 - (k) Require the Auditor to enter into an agreement that provides that for the period of the engagement and for a period of two years from completion of the engagement, the Auditor shall not, without prior written consent of the Commission staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with the Amex, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the Auditor 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 Auditor in performance of his/her duties under this Order shall not, without prior written consent of the Commission staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with the Amex, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.
4. The Amex shall implement the enumerated undertakings within the time specified herein unless, upon written request and for good cause shown by the Amex, the Commission staff grants the Amex such additional time as the Commission staff deems reasonable and necessary to implement any of the enumerated undertakings.

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 Offer.

Accordingly, pursuant to Sections 19(h)(1) and 21C of the Exchange Act, it is hereby ORDERED, that

- A. Respondent Amex be, and hereby is, censured;
- B. Respondent Amex cease and desist from committing or causing any violations and any future violations of Sections 17(a)(1) and 19(g)(1) of the Exchange Act and Exchange Act Rule 17a-1; and
- C. Respondent Amex shall comply with the undertakings enumerated in Section III.F. above.

By the Commission.

Nancy M. Morris
Secretary