

NEW YORK STOCK EXCHANGE, INC.

EXCHANGE HEARING PANEL DECISION 04-2
INTERACTIVE BROKERS LLC
MEMBER ORGANIZATION

January 13, 2004

* * *

Violated Exchange Rule 342 by failing to adequately supervise odd-lot trading practices; allowed customers to effect odd-lot trades contrary to Exchange guidelines; violated Exchange Rule 405(1) by failing to learn essential facts relative to certain customer orders; violated SEC Rules 15c3-3 and 15c3-1 by failing to properly calculate net capital, resulting in two reserve formula hindsight deficiencies; violated SEC Rules 17a-3 and 17a-4 and Exchange Rule 440 by failing to maintain accurate books and records; violated Exchange Rule 431 by failing to identify pattern day traders with respect to margin requirements; violated Exchange Rule 351(d) by not accepting verbal customer complaints – Consent to censure and \$170,000 fine.

Appearances:

For the Division of Enforcement
Allison A. Bishop, Esq.
Robert J. Meyers, Esq.

For the Respondent
Earl Nemser
David M. Battan, Esq.

* * *

An Exchange Hearing Panel met to consider a Stipulation of Facts and Consent to Penalty entered into between the Exchange's Division of Enforcement and Interactive Brokers LLC (the "Firm"), a member organization. Without admitting or denying guilt, the Firm consents to findings by the Hearing Panel that it:

- I. Violated Exchange Rule 342 in that it failed to institute adequate supervisory procedures and controls to detect and/or prevent prohibited odd-lot trading practices, including day trading.
- II. Engaged in conduct inconsistent with just and equitable principles of trade in that the Firm allowed customers to effect odd-lot trades which were contrary to guidelines delineated in Exchange Rules and policies.
- III. Violated Exchange Rule 405(1) in that it failed to use due diligence to learn the essential facts relative to certain customer orders.
- IV. Violated SEC Rules 15c3-3 and 15c3-1 by failing to properly calculate its Net Capital and Customer Reserve Formula computations, resulting in two Reserve Formula hindsight deficiencies.

- V. Violated SEC Rules 17a-3 and 17a-4 and Exchange Rule 440 by failing to make and maintain accurate books and records.
- VI. Violated Exchange Rule 431 by failing to identify pattern day traders and failing to calculate day trading margin power in customer accounts to ensure that customer accounts had the required minimum equity of \$25,000 in their accounts.
- VII. Violated Exchange Rule 351(d) in that it did not accept verbal customer complaints.

For the sole purpose of settling this disciplinary proceeding, the Division of Enforcement and the Firm stipulate to certain facts, the substance of which follows:

Background and Jurisdiction

1. The Firm, an on-line retail brokerage firm, has been an electronic access member of the Exchange since September 1994. The Firm, a broker-dealer registered under the Securities Exchange Act of 1934, executes and clears securities transactions for its customers. The Firm is a member of the Interactive Brokers Group, which is comprised of electronic brokerage and proprietary trading firms that execute trades on over 40 market centers in 17 countries, with over 450 traders, programmers and support staff located in offices and exchange floors throughout the world. The Exchange is the Firm's designated examining authority.
2. The Firm's customers enter stock, options and/or futures orders from their personal computers through the Firm's Trader Workstation system, which transmits the orders directly to the Exchange or other market center. Orders executed at the Exchange are routed through automated trading systems, including the Exchange's Super Designated Order Turnaround System ("SuperDot").
3. In or about February 2002, the Exchange's Division of Market Surveillance ("MKS") referred to the Division of Enforcement the results of its investigation into complaints from three specialist organizations regarding inordinately large volumes of odd-lot orders being sent by the Firm to the Exchange Floor through SuperDot.
4. In or about May 2002, the Exchange's Division of Member Firm Regulation ("MFR") referred to Enforcement the findings of its 2001 review of the Firm's financial, operational and supervisory standards procedures ("FINOP"), contained in a report dated February 4, 2002. The report noted violations by the Firm, which included, among other items, deficiencies in the Firm's reserve formula computation, reconciliation of suspense accounts, and maintenance of required minimum equity in margin accounts. This matter also addresses certain findings from MFR's 2002 FIN/OP report, dated January 29, 2003.
5. By letters dated August 2 and 9, 2002, Enforcement notified the Firm of Enforcement's formal investigation of the matters discussed above.

Summary

6. As set forth below, the Firm failed to establish and maintain adequate supervisory procedures and controls in order to detect and prevent improper odd-lot trading through its order entry systems by its customers. Specifically, from December 1999 through November 2000, certain Firm customers utilized the Firm's Trader Workstation system to access SuperDot and effected abusive odd-lot trading by executing a significant volume of odd-lot trades, which constituted day trading, which is inconsistent with traditional odd-lot investment activity and prohibited by Exchange Rules and policies. Additionally, the Firm failed to accurately compute its Net Capital and Customer Reserve Formula calculations on at least two occasions, resulting in one hindsight reserve deficiency of \$4.6 million in September 2001, and another of \$11.9 million in September 2002. Moreover, the Firm failed to have adequate supervisory procedures to prevent such deficiencies, which also resulted in books and records violations. The Firm also failed to have procedures in place or take steps to ensure that customers who were identified as pattern day-traders pursuant to Exchange rules were designated as such and failed to ensure that these customers maintained the required minimum equity at all times during the year 2001. Further, prior to October 2002, the Firm failed to have adequate procedures in place to record and account for verbal customer complaints and properly report them to the Exchange.

Violative Conduct

Failure to Exercise Due Diligence and Control over Odd-Lot Trading Though the Firm's Order Entry System

7. Pursuant to Exchange Rule 342, members and member organizations are required, among other things, to provide for appropriate procedures for supervision and control over every area of their business activities and to establish a system for follow-up and review with respect to their compliance with Exchange Rules and federal securities laws. As noted herein, the Firm did not adhere to the requirements of Exchange Rule 342, as it pertains to the Firm's duties concerning odd-lot trading, customer reserve and net capital computations, as described in more detail herein.
8. Pursuant to Exchange Rule 405, members and member organizations, acting through appropriate supervisory personnel, must use due diligence to learn the essential facts relative to every customer and order.
9. Member organizations are given access to the Exchange's SuperDot order entry system (an electronic order entry system that sends orders directly to the Exchange Floor), and are also permitted to grant this access to their affiliated companies and non-member customers. However, member organizations that provide their non-broker-dealer customers with the ability to electronically transmit orders through the member's SuperDot line are required to ensure that the non-member customers and other entities using SuperDot comply with Exchange Rules and policies.

10. Member organizations, such as the Firm, that provide their non-broker-dealer customers with the ability to electronically transmit orders through the member's SuperDot line must satisfy their regulatory obligations to detect and prevent abuses by their customers for orders directed to the Trading Floor through the use of the Firm's SuperDot lines. Consequently, a member is responsible for all orders that are sent to the Exchange Floor via SuperDot, even if sent by an affiliated company or non-member customer.
11. In February 1991 the Exchange introduced a new odd-lot limit order service, which afforded members and member organizations an efficient and inexpensive order execution system compatible with traditional odd-lot investing practices of smaller investors.
12. In order to ensure that this service is not abused, the Exchange prohibits certain trading practices through the odd-lot system. These prohibited practices include, but are not limited to, order entry practices intended to circumvent the round-lot auction market and the entry of orders evidencing "any pattern of activity that would suggest day trading".
13. The Exchange's policies concerning odd-lot trading practices and order entry via SuperDot are contained in "Information Memos", which were distributed to all members and member organizations. They are found in Information Memo No. 89-6 (January 25, 1989), Information Memo No. 91-29 (July 25, 1991), Information Memo No. 92-25 (September 28, 1992), Information Memo No. 94-14 (April 18, 1994) and Information Memo No. 97-43 (August 19, 1997).
14. In these memos, the Exchange delineated certain odd-lot practices that were not consistent with the use of the Exchange odd-lot system. For example, in Information Memo No. 91-29 (July 25, 1991), members and member firms were advised of their obligation to establish and enforce appropriate systems to monitor odd-lot activity to ensure that prohibited practices did not occur, such as entering both buy and sell odd-lot limit orders in the same stock before one of the orders was executed for the purpose of capturing the "spread" in the stock.
15. Information Memo No. 94-14 (April 18, 1994) notified members and member firms of other examples of odd-lot trading inconsistent with traditional odd-lot investment activity; for example index arbitrage, certain types of program trading or any pattern of activity that would suggest day trading.
16. In addition, members and member firms are required to impose basic regulatory requirements such as exercising diligence as to accounts. Pursuant to Exchange Information Memo No. 89-6 (January 25, 1989), members and member firms are required to complete an attestation acknowledging the firms' responsibility for orders sent to the Exchange and acknowledging the firms' obligations to impose appropriate regulatory and supervisory procedures in connection with orders directed to SuperDot.

17. From December 1999 through November 2000, the Firm failed to have appropriate procedures of supervision and control and a separate system of follow-up and review to ensure that odd-lot orders entered by the Firm's customers did not violate Exchange Rules and odd-lot policies, as set forth by the Exchange. In addition, prior to being alerted by the Exchange, the Firm did not monitor or survey for abusive odd-lot customer trading, which resulted in the violations set forth below.
18. Specifically, on November 1, 2000, the Exchange's On-Floor Surveillance Unit received two complaints concerning unusually heavy odd-lot limit order activity. The complaints involved two particular stocks.
19. An investigation into these complaints revealed that for the week of October 25, 2000 through October 31, 2000, the Firm's executions through SuperDot accounted for 94% to 97% of the odd-lot activity in one of the stocks and 94% to 96% of the odd-lot activity in the other stock for that week.
20. In addition to the above complaints, a complaint was received on November 2, 2000, concerning possible odd-lot abuse in another stock. The investigation revealed that the Firm accounted for 92% of the odd-lot activity in that stock on November 1, 2000 and between 88% and 95% of the odd-lot activity in that stock for the week of October 25, 2000 through October 31, 2000.
21. From December 1999 through November 2000, at least nine Firm customers effected improper odd-lot transactions via the Firm's SuperDot lines by entering a significant number of buy and sell odd-lot limit orders in the same stock for the purpose of capturing the spread in the stock.
22. All of the reviewed customers traded heavily in odd-lots of Exchange traded securities. For example, on November 1, 2000 one customer entered and executed 1,852 trades in six issues with an aggregate volume of approximately 183,348 shares, demonstrating a pattern of day trading by utilizing the Firm's SuperDot line.
23. A review of other trade dates prior to November 2000 revealed similar activity by the above-noted Firm customers. All of the orders were limit orders to buy and sell a listed security resulting in a flat position on a daily basis or at the end of the month.
24. The aforementioned examples establish that the Firm permitted or facilitated its customers' entry of odd-lot limit orders through SuperDot in a manner that constituted day trading through SuperDot, and which is both inconsistent with and in contravention of Exchange Rules and policies with respect to odd-lot trading.
25. The Firm did not have a system of surveillance in place to determine whether the Firm's customers were effecting prohibited odd-lot trades or trades that were not in conformity with Exchange odd-lot trading rules and policies. Accordingly, the Firm failed to adequately supervise its customers' odd-lot orders and executions and failed to learn the essential facts relative to its customers' orders and thus impose appropriate regulatory and supervisory procedures with respect to these odd-lot orders.

Customer Reserve Formula and Net Capital Computation –
SEC Rules 15c3-3 and 15c3-1
Books and Records

26. The Firm failed to reasonably supervise and implement appropriate procedures of supervision and control over its customer reserve formula and net capital calculations, including a separate system of follow-up and review to assure that the Firm's net capital and customer reserve formula computations were calculated correctly, and failed to have adequate systems and procedures in place to ensure that the required calculations were completed in an accurate manner, in accordance with Exchange Rules and federal securities regulations and laws.
27. In addition, as set forth below, from July 2001 through November 2001 the Firm failed to have appropriate procedures of supervision and control and a separate system of follow-up and review to adequately supervise the Firm Controller and other Firm employees responsible for preparing the net capital and customer reserve formulas in accordance with Exchange rules and federal securities regulations and laws.
28. SEC Regulation §240.15c3-3 promulgated under the Securities Exchange Act of 1934 (the "Exchange Act") requires, among other things, that a broker or dealer maintain a Special Reserve Bank Account for the Exclusive Benefit of Customers ("Reserve Bank Account") separate from any other account of the broker or dealer.
29. The Reserve Bank Account is to be funded through deposits by the broker or dealer of cash and/or qualified securities in amounts computed, at least weekly, in accordance with the reserve requirement formula set forth in SEC Rule 15c3-3 ("Reserve Formula Computation"), as are necessary to maintain that account at a minimum required level in a timely manner.
30. SEC Regulation §240.15c3-1 provides, in relevant part, that a broker or dealer must maintain at all times net capital at the level required by the Regulation, before engaging in securities transactions.
31. SEC Rule 17a-3 requires, in relevant part, that every broker-dealer shall make and keep current records, including those required for net capital and special reserve account computations. SEC Rule 17a-4 delineates the length of time broker-dealers are required to maintain such records. Exchange Rule 440 requires every member organization to make and preserve books and records as prescribed by the Exchange and by SEC Rules 17a-3 and 17a-4.
32. The Firm was not in compliance with SEC Rule 15c3-3 in that an analysis of the customer reserve formula computation as of September 28, 2001 revealed a hindsight deficiency of \$4,674,638 in the Special Reserve Bank Account. The hindsight deficiency resulted primarily from the Firm's failure to include, as a credit, aged suspense items totaling \$6.9 million, and other minor adjustments.

33. This deficiency resulted from the Firm's failure to properly pair off certain items as required. For example, certain entries were inadvertently booked to the Firm's suspense accounts and not "paired off" or identified as subsequently resolved and removed from suspense accounts. Also, certain entries were made to the Firm's suspense accounts, and the offsetting entries that would have "paired off" such suspense account entries were booked into other accounts. These erroneous entries resulted in larger gross debit and credit balances in suspense. As a result, on January 11, 2002 the Firm notified the appropriate regulatory agencies of a reserve formula hindsight deficiency in the amount of \$4,674,638.
34. In addition, a review of the Firm's net capital computation of September 28, 2001 revealed that the Firm failed to take a charge to net capital, as a result of the above mentioned aged suspense items, in the amount of \$6.6 million, which decreased excess net capital from \$53.7 million to \$47.1 million. These violations stemmed not only from the Firm failing to take a capital charge for aged suspense items, but also from netting unrelated assets and liabilities and not taking a charge for aged bank reconciliation differences. The Firm's net capital miscalculations violated SEC Rule 15c3-1.
35. By failing to include aged suspense items, failing to reflect a charge to capital for aged suspense items, failing to properly reflect certain adjustments such as unsecured debits, aged suspense items and other erroneous entries in the Firm's books and records, and improperly netting balances in unrelated suspense accounts for FOCUS balance sheet presentations, the Firm's books and records were not current or accurate, resulting in books and records violations under SEC Rules 17a-3 and 17a-4 and Exchange Rule 440.
36. Further, a review of the suspense accounts disclosed that the Firm did not prepare reconciliations for three out of five accounts identified by the Exchange. The Firm was not adequately evaluating the accounts to determine whether they were current or accurate.
37. In addition, as part of the 2002 FINOP Exchange examination, a review of the reserve formula computation for September 30, 2002 disclosed various adjustments resulting in an \$11.9 million hindsight deficiency. The Firm sent notification to the appropriate regulatory agencies concerning the hindsight deficiency on December 31, 2002.
38. The September 30, 2002 hindsight deficiency was primarily attributable to the Firm using non-qualified equity securities (not guaranteed by the U.S. Government), to meet its Options Clearing Corporation ("OCC") customer margin requirement.
39. Specifically, equity securities the Firm had pledged to OCC to secure customer margin debt was allowable as margin at the OCC, but not allowable as a debit item in the reserve calculation. After Exchange Staff brought this matter to the Firm's attention, the Firm immediately pledged U.S. Treasury Bills to support customer margin obligations at the OCC.

Exchange Rule 431
Margin Maintenance Requirements for Day Trading

40. The Firm failed to have appropriate procedures of supervision and control and a separate system of follow-up and review to ensure that the Firm was in compliance with day trading margin requirements pursuant to Exchange rules and federal securities laws.
41. Information Memo No. 01-09 (April 2, 2001), notified members that the SEC had approved amendments to Rule 431 (“Margin Requirements”), which established new requirements to address intraday risks associated with day trading. These changes included, among other things, that margin requirements be based on a day trader’s activities during the day, rather than on open securities positions at the end of the day. Under Rule 431 (f)(8)(B), the minimum equity required for “day traders” is \$25,000.
42. Exchange Rule 431 (f)(8)(B)(ii), as amended, defines “pattern day trader” as any customer who executes four or more day trades within five business days, provided the number of day trades is more than 6% of the total trades in the account during that period.
43. The Exchange’s review of the Firm’s customer accounts revealed that certain accounts were engaging in day trading-type activities and revealed that the Firm did not use either of the specified methods to calculate purchasing power and compute maintenance requirements as required by Exchange Rule 431.
44. During the year 2001, the Firm failed to properly identify at least five “pattern day traders” at the Firm, and failed to require that these customers maintain the minimum equity of \$25,000 at all times.
45. Based on the above, the Firm violated Exchange Rule 431 in that it failed to properly identify “pattern day traders” and failed to calculate day trading margin power in these customer accounts to ensure that these customer accounts had the required minimum equity of \$25,000 in their accounts as required by Exchange Rule 431.

Reporting Requirements – Customer Complaints

46. The Firm failed to have appropriate procedures of supervision and control and a separate system of follow-up and review to ensure that all verbal and written complaints were accurately reported to the Exchange and dealt with in accordance with Exchange rules and federal securities laws.
47. Exchange Rule 351 requires, in relevant part, that each member and member organization promptly report to the Exchange any matter reportable under the Rule. Paragraph (d) under the Rule requires each member and member organization to report to the Exchange on a quarterly basis certain statistical information regarding customer complaints.

48. Information Memo No. 98-16 (April 14, 1998) reiterated that oral complaints were reportable under Exchange Rule 351(d). Pursuant to that Information Memo, members and member organizations are required to treat all customer complaints, oral and written, with equal scrutiny and report them to the Exchange in the quarterly report of customer complaint statistics.
49. Prior to being advised by the Exchange of its duty to do so, the Firm failed to report verbal complaints to the Exchange. Specifically, until October 2002, the Firm did not accept complaints from customers who called into the Firm with oral complaints. Prior to October 2002, it was the Firm's usual practice to inform customers that all complaints had to be submitted to the Firm in writing if they could not be resolved during the course of the customer's call. This practice, however, was not consistent with Rule 351(d), which requires reporting of oral complaints, because these oral complaints were not reported to the Exchange and the Firm had no mechanism in place to account for the complaints, or determine whether they had been reduced to writing.
50. Further, the Firm failed to track these verbal complaints to determine whether a particular customer did in fact follow up with a written complaint.
51. Additionally, the Firm was not in compliance with Exchange reporting requirements in that the Firm failed to accurately report certain complaints within the appropriate complaint codes as delineated in Exchange Rule 351(d) as well as Information Memo No. 99-32 (June 23, 1999), and Information Memo No. 01-13 (June 21, 2001).
52. For example, a review of 62 operational complaints disclosed nine instances (15%) where the Firm could not evidence that a response was made to the customer complaint; ten instances (16%) where the Firm's response did not adequately address the customer complaint; and 28 instances (44%) where the complaints were incorrectly classified as to product and/or problem code.
53. In addition, during the time period of January 2001 through November 2001, the Firm was aware of complaints relating to the execution of stop orders and good till cancelled ("GTC") orders. In particular, customers complained that their stop orders and GTC orders were delayed or were not executed. During this period, the Firm failed to adequately address and/or communicate with its customers regarding these execution problems and to properly report these complaints to the Exchange.

Other Factors Considered

54. The Firm has informed the Exchange, and the Exchange has considered the following circumstances in connection with the matters set forth above:
 - a) When the Exchange notified the Firm in November 2000 of the excessive odd-lot trading by the Firm's customers, the Firm took immediate steps to prevent customers from engaging in improper odd-lot activity.
 - b) None of the deficiencies cited herein resulted in a loss to Firm customers.

- c) At all times the Firm had sufficient liquid net capital to make required deposits into the Reserve Bank Account to cover the hindsight deficiencies (as of the date of the 2001 and 2002 FINOP audits, the Firm had excess net capital in excess of \$54 million and \$79 million respectively). When the miscalculations related to customer reserve and net capital came to light, the Firm took immediate steps to address the deficiencies, including enhancing Firm procedures and adding additional personnel to improve reconciliation and review of Firm accounting obligations on an ongoing basis.
- d) The Firm has represented to the Exchange that it has enhanced its complaint tracking and reporting systems. Specifically, the Firm has instituted a “call logger” system that allows Firm customer service representatives to log all verbal complaints and track such complaints for purposes of managerial oversight and compliance with applicable Exchange rules.

DECISION

The Hearing Panel, in accepting the Stipulation of Facts and Consent to Penalty, found the Firm guilty as set forth above by unanimous vote.

PENALTY

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by the Firm of a censure and a fine in the amount of \$170,000.

For the Hearing Panel

Milton M. Stein
Hearing Officer