

NYSE ARCA, INC.

HEARING BOARD DECISION 09-ARCA-12

December 9, 2009

CUTLER GROUP L.P.

OTP HOLDER

* * *

Violated Section 17(a)(1) of Exchange Act, and Rules 17a-4(b)(4) and 17a-4(f) thereunder, and NYSE Arca Options Rule 11.16(a), by failing to preserve business-related e-mail and instant messages in non-rewriteable, non-erasable format, and by failing to preserve business-related fax communications; violated NYSE Arca Options Rule 11.3—Commentary .03 by failing to maintain complete and accurate list of accounts in which employees had direct or indirect financial interest, and by failing to obtain, maintain and review monthly account statements for accounts in which employees had direct or indirect financial interest; violated NYSE Arca Options Rule 11.3(a) by failing to establish, maintain, or enforce adequate written policies and procedures reasonably designed to prevent misuse of material, non-public information by employees; violated Section 17(a)(1) of Exchange Act, and Rule 17a-3(a)(12) thereunder, and NYSE Arca Options Rule 11.16(a), by failing to appropriately conduct and document background checks of employees prior to employment, and by failing to properly retain and preserve manually signed Forms U-4; violated NYSE Arca Options Rule 11.18 by failing to establish, maintain, and/or enforce appropriate written policies and procedures for supervision and control, including separate system of follow-up and review, in following areas: (a) conducting and documenting background checks of employees prior to employment, including maintaining complete and accurate signed Forms U-4; (b) retention in proper format and review of business-related e-mails, instant messages and faxes sent or received by employees; and (c) prevention of misuse of material, non-public information by employees - Consent to censure and \$20,000 fine.

Appearances:

For Division of Enforcement
Steven Brostoff, Esq.
Lara Posner, Esq.
Joseph O. Okpaku, Esq.

For Respondent
J. Micah Glick

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A Hearing Officer on behalf of the General Counsel of NYSE Arca, Inc. (“NYSE Arca”) considered an Offer of Settlement and Consent (“Offer of Settlement”) executed by Cutler Group L.P. (“Respondent” or the “Firm”), an NYSE Arca OTP holder.¹

The Offer of Settlement was submitted for the sole purpose of settling this disciplinary proceeding, without adjudication of any issues of law or fact, and without admitting or denying any allegations or finding referred to therein. The Division of Enforcement of NYSE Regulation, Inc. does not contest the Offer of Settlement, and recommends its acceptance. With due regard to the stipulated facts and violations and the proposed sanction contained therein, the Hearing Officer believes it is appropriate to accept the Offer of Settlement and issues this Decision in accordance with NYSE Arca Options Rules. The Offer of Settlement is made a part of this Decision by reference herein.

Stipulation of Facts and Violations

Background and Jurisdiction

1. The Firm is a proprietary trading firm with offices in Chicago, New York, Philadelphia and San Francisco. The Firm was founded in San Francisco and became registered as an Options Trading Permit (“OTP”) holder with the Pacific Stock Exchange, now known as NYSE Arca Inc. (“NYSE Arca Options” or the “Exchange”), in 1994. The Firm is also a member the Chicago Board of Exchange and the American Stock Exchange. The Firm’s business consists primarily of equity option market making; however, the Firm is not a brokerage firm and therefore does not provide any brokerage-related services. The Firm maintains a staff of under a hundred employees.
2. On behalf of NYSE Arca Options, the Financial Industry Regulatory Authority’s (“FINRA”) Division of Member Firm Regulation (“MFR”) conducted a financial, operational and supervisory (“FINOP”) examination of the Firm in 2006 and 2007. By letters to the Firm dated January 18, 2007 and January 17, 2008, MFR detailed the findings of its 2006 FINOP examination (the “2006 FINOP Report”) and its 2007 FINOP examination (the “2007 FINOP Report”), respectively.

¹ Prior to the closing of the merger between the New York Stock Exchange (“NYSE”) and Archipelago Holdings, LLC on March 7, 2006, the exchange now designated as NYSE Arca Options was known as the Archipelago Exchange (“ArcaEx”), and was governed by the rules of PCX, Inc. (“PCX”). The applicable rules were not changed by the merger, and for convenient reference, this document refers to the former ArcaEx as “NYSE Arca Options” and the governing rules as “NYSE Arca Options Rules,” even when referring to pre-merger periods.

3. By letter dated June 20, 2008, which the Firm received, the Division of Enforcement (“Enforcement”) of NYSE Regulation, Inc. notified the Firm that it was investigating the matters contained in the 2006 FINOP Report. Thereafter, by letter dated July 15, 2008, which the Firm also received, Enforcement notified the Firm that it would be conducting an investigation into potential violations of various NYSE Arca Options rules and federal securities laws contained in the 2007 FINOP Report.

OVERVIEW

4. This matter primarily involves books and records and supervisory deficiencies disclosed during the periods of review in the 2006 and 2007 FINOP Reports. The Firm’s violative activity included: failure to preserve certain electronic communications in the required format; failure to maintain a complete and accurate list of accounts in which its employees had a direct or indirect financial interest; failure to obtain, maintain and review monthly account statements for accounts in which its employees had a direct or indirect financial interest; failure to file a complete and accurate annual acknowledgment attestation with the Exchange; failure to appropriately conduct background checks of its associated persons; and failure to establish, maintain, and/or enforce appropriate written policies and procedures for supervision and control, including a separate system of follow-up and review, with respect to certain of the foregoing areas.

VIOLATIVE CONDUCT

Instant Messages, E-Mails, and Fax Communications

5. Section 17(a)(1) of the Securities Exchange Act of 1934 (“Exchange Act”) and Rule 17a-4(b)(4) thereunder require member firms to preserve originals of all communications received and copies of all communications sent by members relating to its business, for a period of not less than three years, the first two years in an easily accessible place. The format requirements for records required to be kept pursuant to Rule 17a-4 are set forth in subsection (f), which provides, in pertinent part, that “[i]f electronic storage media is used by a member, broker, or dealer ... [t]he electronic storage media must ... [p]reserve the records exclusively in a non-rewriteable, non-erasable format.”
6. NYSE Arca Options Rule 11.16(a), which pertains to the duty to make and maintain books and records, states in part: “[e]ach OTP Holder and OTP Firm must make, keep current and preserve such books and records as the Exchange may prescribe and as may be prescribed by the Exchange Act and the rules and regulations thereunder (including any interpretation relating thereto) as though such OTP Holder or OTP Firm were a broker or dealer registered with the SEC pursuant to Section 15 of the Exchange Act.”
7. NYSE Arca Options Rule 11.18(a) requires each OTP Holder or OTP Firm to supervise associated persons to assure compliance with federal securities laws and

NYSE Arca Options Rules. NYSE Arca Options Rule 11.18(b) requires each OTP Holder or OTP Firm to “establish and maintain a system to supervise the activities of its associated persons and the operations of its business. Such system must be reasonably designed to ensure compliance with applicable federal securities laws and regulations and NYSE Arca Rules.” Pursuant to NYSE Arca Options Rule 11.18(c), each OTP Holder or OTP Firm must “establish, maintain, and enforce written procedures to supervise the business in which it engages and to supervise the activities of its associated persons that are reasonably designed to ensure compliance with applicable federal securities laws and regulations, and with the NYSE Arca Rules.”

8. NYSE Arca Regulatory Bulletin RB-05-02, dated January 5, 2005, entitled “Clarification Regarding Supervisory Obligations and Recordkeeping Requirements for E-Mail and Instant Messages,” states that a firm’s supervision of instant messages is the same as that for e-mails. It states that if a firm “is unable to establish an adequate supervisory program, the ... [firm] must prohibit the use of instant messaging. OTP ... Holders must also ensure that their use of instant messaging complies with applicable SEC recordkeeping requirements.” NYSE Arca Regulatory Bulletin RBO-04-04, dated January 7, 2004, titled “Clarification for Members Regarding Supervisory Obligations and Recordkeeping Requirements for E-Mail and Instant Messages,” sets forth similar requirements for retaining e-mails and instant messages.
9. Through the time of the 2006 FINOP examination, the Firm failed to preserve e-mail and instant messages in a non-rewriteable, non-erasable format², and failed to conduct any supervision or review of instant messages sent and received by the Firm’s employees and associated persons.
10. Through the time of the 2007 FINOP examination, the Firm again failed to conduct any supervision or review of instant messages. In addition, the Firm was unable to provide any evidence that faxes were being reviewed and maintained.
11. Accordingly, the Firm violated Section 17(a)(1) of the Exchange Act, and Rules 17a-4(b)(4) and 17a-4(f) thereunder, and NYSE Arca Options Rules 11.16(a) and 11.18.

Prevention of the Misuse of Material, Nonpublic Information

12. NYSE Arca Options Rule 11.3(a) states that “Every OTP Holder or OTP Firm must establish, maintain and enforce written policies and procedures reasonably designed...to prevent the misuse of material, non-public information by such OTP Holder or OTP Firm or persons associated with such OTP Holder or OTP Firm.” Commentary .03 (C) to NYSE Arca Options Rule 11.3 states: “Each OTP Holder or OTP Firm must receive and retain copies of trade confirmations and monthly account statements for each account in which an Associated Person [] has a direct or indirect financial interest or makes investment decisions. The activity in such brokerage

² This format is also known as the “WORM” (write once read many) format.

accounts should be reviewed at least quarterly by the OTP Holder or OTP Firm for the express purpose of detecting the possible misuse of material, non-public information.”

13. The 2006 FINOP examination found that the Firm’s procedures regarding the review of trading activity in the accounts of its employees for the possible misuse of material, nonpublic information were inadequate. The Firm was unable to provide a complete and accurate list of accounts in which associated persons of the Firm had a direct or indirect financial interest for four associated persons or an attestation that the associated persons in question had no such accounts. It was further determined that these four associated persons did have securities accounts, and the Firm had failed to obtain their account statements.
14. The 2007 FINOP Report found additional failures in that the Firm was unable to provide a complete set of account statements of five associated persons. Furthermore, for the two accounts for which statements were provided, there was no evidence of supervisory review.
15. Accordingly, the Firm violated NYSE Arca Options Rules 11.3(a), NYSE Arca Options Rule 11.3—Commentary .03, and NYSE Arca Options Rule 11.18.

Background Checks of Associated Persons

16. Section 17(a)(1) of the Exchange Act and Rule 17a-3(a)(12) thereunder sets forth the required documents and information that each firm must obtain in connection with applications for employment for associated persons³, including name, address, social security number, date of birth, past 10 years business connections and employment history and prior disciplinary actions.
17. In addition, NYSE Arca Regulatory Bulletin RBO-02-06, dated February 12, 2002, titled “Supervision Obligations of Members and Member Organizations,” states that member firms must verify the accuracy and completeness of all information contained in each associated person’s Form U-4, and must verify prior employment of new employees prior to hire.
18. The 2006 examination found that the Firm was unable to provide manually signed Forms U-4 for four of the six Firm employees selected for review. The 2006 examination also found that the Firm failed to verify the accuracy and completeness of all the information contained in one of the Firm’s associated person’s Form U-4, and that the Firm failed to verify the prior employment of new employees.

³ Pursuant to NYSE Arca Options Rule 1.1(d), the term "Associated Person" refers to a person who is a partner, officer, director, member of a limited liability company, trustee of a business trust, employee of an OTP Firm or any person directly or indirectly controlling, controlled by or under common control with an OTP Firm.

19. In addition, the 2007 examination found that the Firm was again unable to provide a manually signed Form U-4 for a Firm employee. The 2007 examination also noted that although the Firm claimed to have verified the accuracy and completeness of all information contained in the Forms U-4 of new associated persons, the Firm was unable to provide any evidence of such reviews, or of any type of background check performed with respect to newly-hired associated persons
20. For these reasons, the Firm violated Section 17(a)(1) of the Exchange Act and Rule 17a-3(a)(12) thereunder, as well as NYSE Arca Options Rule 11.16(a), by, in 2006 and 2007, failing to appropriately conduct and document background checks of its employees prior to employment, and by failing to properly retain and preserve manually signed Forms U-4. The Firm also violated NYSE Arca Options Rule 11.18 by failing to ensure that employment verifications of its associated persons were being properly conducted and documented and that complete and accurate signed Forms U-4 were being maintained.

FINDINGS OF VIOLATIONS

21. Respondent violated Section 17(a)(1) of the Exchange Act, and Rules 17a-4(b)(4) and 17a-4(f) thereunder, and NYSE Arca Options Rule 11.16(a), by failing to preserve business-related e-mail and instant messages in a non-rewriteable, non-erasable format, and by failing to preserve business-related fax communications.
22. Respondent violated NYSE Arca Options Rule 11.3—Commentary .03 by failing to maintain a complete and accurate list of accounts in which its employees had a direct or indirect financial interest, and by failing to obtain, maintain and review monthly account statements for accounts in which its employees had a direct or indirect financial interest.
23. Respondent violated NYSE Arca Options Rule 11.3(a) by failing to establish, maintain, or enforce adequate written policies and procedures reasonably designed to prevent the misuse of material, non-public information by its employees.
24. Respondent violated Section 17(a)(1) of the Exchange Act, and Rule 17a-3(a)(12) thereunder, and NYSE Arca Options Rule 11.16(a), by failing to appropriately conduct and document background checks of its employees prior to employment, and by failing to properly retain and preserve manually signed Forms U-4.
25. Respondent violated NYSE Arca Options Rule 11.18 by failing to establish, maintain, and/or enforce appropriate written policies and procedures for supervision and control, including a separate system of follow-up and review, in the following areas:
 - a. conducting and documenting background checks of its employees prior to employment, including maintaining complete and accurate signed Forms U-4;

- b. retention in proper format and review of business-related e-mails, instant messages and faxes sent or received by its employees; and
- c. the prevention of the misuse of material, non-public information by its employees.

DECISION

The Hearing Officer accepted the Offer of Settlement as set forth above, and Respondent is found to have committed the violations contained therein.

PENALTY

In accordance with the Offer of Settlement, Respondent is hereby censured and fined \$20,000.

For the Hearing Board

Peggy Kuo - Chief Hearing Officer