

## NYSE ARCA, INC.

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| NYSE REGULATION,        |  |
| Complainant,            | FINRA Proceeding No. 20120347730-01 <sup>1</sup> |
| v.                      |  |
| INTERACTIVE BROKERS LLC | May 23, 2017                                     |
| Respondent.             |  |

**Respondent violated: (i) Exchange Act Rules 15c3-5(b) and (c)(1)(ii), and NYSE Arca Equities Rules 6.18 and 2010, by failing to establish, document, and maintain a system of risk management controls and supervisory procedures, including written supervisory procedures and an adequate system of follow-up and review, reasonably designed to manage the financial, regulatory, and other risks of its market access business, including pre-trade controls to prevent the entry of erroneous orders by rejecting orders that exceed appropriate price or size parameters; and (ii) Exchange Act Rules 15c3-5(b) and (c)(2), and NYSE Arca Equities Rules 6.18 and 2010, by failing to establish, document, and maintain a system of risk management controls and supervisory procedures, including written supervisory procedures and an adequate system of follow-up and review, reasonably designed to manage the financial, regulatory, and other risks of its market access business to ensure compliance with all regulatory requirements, including supervising customer trading to detect and prevent potentially violative activity. Consent to a censure, a \$230,000 fine, and an undertaking.**

### Appearances

For the Complainant: Jason A. Harman, Esq., Kenneth R. Bozza, Esq., and Robert A. Marchman, Esq., FINRA Department of Market Regulation.

For the Respondent: David M. Battan, Esq., and Scott M. Litvinoff, Esq. Interactive Brokers LLC.

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<sup>1</sup> Includes merged STAR Nos. 20130358268, 20130392978, 20140399418, 20150448964, 20150460127, 20150474721, and 20160494473.

## DECISION

Interactive Brokers LLC (“Interactive Brokers” or “Firm”) and NYSE Arca, Inc. entered into an Offer of Settlement and Consent 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 findings referred to in the offer of settlement.<sup>2</sup> The Hearing Officer accepts the Offer of Settlement and Consent and issues this Decision in accordance with NYSE Arca Equities Rules.<sup>3</sup>

### FINDINGS OF FACTS AND VIOLATIONS

#### Background and Jurisdiction

1. Interactive Brokers is a Connecticut limited liability company with its principal place of business located in Greenwich, Connecticut. The Firm acts as an agency broker-dealer, providing market access, execution, and clearing services to market participants (“Market Access Customers”) for a wide variety of electronically traded products, including stocks, options, futures, forex, bonds, and funds worldwide.
2. The Firm has been registered as an Equities Trading Permit (“ETP”) Holder with NYSE Arca, Inc. (“NYSE Arca Equities” or the “Exchange”) since December 13, 2000, and with FINRA since January 6, 1995. Its registrations remain in effect.
3. Jurisdiction letters were sent to the Firm on June 2, 2014, October 21, 2014, June 22, 2015, and February 8, 2016, notifying the Firm of investigations by FINRA’s Department of Market Regulation (“Market Regulation”) into the matters referenced herein.

#### Relevant Disciplinary History

4. In April 2013 the Firm was fined a total of \$82,500 and issued an undertaking in two related matters for its failure to adequately supervise customer trading for potentially manipulative activity, including wash sales, pre-arranged trades and marking-the-close, during the periods of December 1, 2009, through May 17, 2010, and October 8, 2010, through March 18, 2011, in violation of NASD Rule 3010, FINRA Rule 2010, and NASDAQ Rules 2110 and 3010.<sup>4</sup>

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<sup>2</sup> FINRA’s Office of Hearing Officers reviewed the Offer of Settlement and Consent under the terms of a Regulatory Services Agreement (as amended) among NYSE Group, Inc., New York Stock Exchange LLC, NYSE Arca, Inc., NYSE MKT LLC, and FINRA.

<sup>3</sup> The facts, allegations, and conclusions contained in this Decision were taken from the executed Offer of Settlement and Consent.

<sup>4</sup> See FINRA Matter No. 20100234784 (April 5, 2013) (Firm fined \$57,500); and NASDAQ Matter No. 20110274228 (April 5, 2013) (Firm fined \$25,000).

## Overview

5. In Matter No. 20120347730, the Market Analysis Section of Market Regulation conducted reviews of Clearly Erroneous Executions (“CEEs”) that occurred on the Exchange during the period between July 14, 2011, and December 31, 2011, and the Firm’s risk management controls and supervisory procedures for compliance with Rule 15c3-5 of the Securities Exchange Act of 1934 (“Exchange Act”) (the “Market Access Rule”).<sup>5</sup>
6. In Matter No. 20130358268, the Trading and Financial Compliance Examination (“TFCE”) Section (formerly TMMS) of Market Regulation conducted reviews of CEEs that occurred on the Exchange during 2013, and the Firm’s compliance with the Market Access Rule.
7. In Matter No. 20140399418, the TFCE Section of Market Regulation conducted reviews of CEEs that occurred on the Exchange during 2014, and the Firm’s compliance with the Market Access Rule.
8. In Matter No. 20150448964, the Market Analysis Section of Market Regulation conducted reviews of CEEs that occurred on the Exchange between January 1, 2014, and December 31, 2014, and the Firm’s compliance with the Market Access Rule.
9. In Matter No. 20160494473, the Market Analysis Section of Market Regulation conducted a review of the Firm’s pre-trade price controls for the period between January 1, 2013, and January 31, 2016, and the Firm’s compliance with the Market Access Rule.
10. In Matter No. 20130392978, the Chicago Equities Section of Market Regulation conducted reviews of potentially violative or manipulative trading activity by the Firm customers that occurred on the Exchange between August 1, 2013, and July 30, 2015, and the Firm’s compliance with the Market Access Rule.
11. In Matter No. 20150460127, the Chicago Equities Section of Market Regulation conducted reviews of potentially violative or manipulative trading activity by the Firm customers that occurred on the Exchange between July 1, 2013, and December 31, 2015, and the Firm’s compliance with the Market Access Rule.
12. In Matter No. 20150474721, the Chicago Equities Section of Market Regulation conducted reviews of potentially violative or manipulative trading activity by the Firm customers that occurred on the Exchange between April 1, 2015, and July 31, 2015, and the Firm’s compliance with the Market Access Rule.

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<sup>5</sup> The Securities and Exchange Commission (“SEC”) adopted Rule 15c3-5 effective July 14, 2011. *See* 17 C.F.R. § 240.15c3-5, *Risk Management Controls for Brokers or Dealers with Market Access*, 75 Fed. Reg. 69792, 69792 (Nov. 15, 2010) (Final Rule Release).

13. The above matters were part of investigations conducted by Market Regulation on behalf of NYSE Arca Equities and other self-regulatory organizations, including Bats BZX Exchange, Inc., Bats EDGA Exchange, Inc., Bats EDGX Exchange, Inc., and NASDAQ Stock Market LLC (collectively, the “SROs”), that reviewed the Firm’s compliance with the Market Access Rule and the supervisory rules of the SROs, including NYSE Arca Equities Rules 6.18 and 2010, during the period of July 14, 2011, through at least January 31, 2016 (the “Review Period”).
14. As a result of Market Regulation’s investigations, it was determined that, during the Review Period, Interactive Brokers failed to establish, document, and maintain a system of risk management controls and supervisory procedures, including written supervisory procedures and an adequate system of follow-up and review, reasonably designed to manage the financial, regulatory, and other risks of its market access business.
15. Specifically, from July 14, 2011, through at least January 31, 2016, the Firm failed to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to prevent the entry of erroneous orders by rejecting orders that exceed appropriate price or size parameters, in violation of Exchange Act Rules 15c3-5(b) and (c)(1)(ii), and NYSE Arca Equities Rules 6.18 and 2010.
16. In addition, from July 1, 2013, through at least December 31, 2015, the Firm failed to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to ensure compliance with all regulatory requirements, including supervising customer trading to detect and prevent potentially violative and manipulative activity, in violation of Exchange Act Rules 15c3-5(b) and (c)(2), and NYSE Arca Equities Rules 6.18 and 2010.

## **Violations**

### **Applicable Rules**

17. During the Review Period, Exchange Act Rule 15c3-5(b) required broker-dealers that provide market access to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of their market access business.<sup>6</sup>
18. During the Review Period, Exchange Act Rule 15c3-5(c)(1)(ii) specifically required market access broker-dealers to have financial risk management controls and supervisory procedures reasonably designed to prevent the entry of erroneous orders, by rejecting

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<sup>6</sup> Rule 15c3-5 requires that, as gatekeepers to the financial markets, broker-dealers providing market access must “appropriately control the risks associated with market access so as not to jeopardize their own financial condition, that of other market participants, the integrity of trading on the securities markets, and the stability of the financial system.” 17 C.F.R. § 240.15c3-5, 75 Fed. Reg. 69792, 69792 (Nov. 15, 2010).

orders that exceed appropriate price or size parameters, on an order-by-order basis or over a short period of time, or that indicate duplicative orders.

19. During the Review Period, Exchange Act Rule 15c3-5(c)(2) specifically required market access broker-dealers to have regulatory risk management controls and supervisory procedures reasonably designed to ensure compliance with all regulatory requirements.
20. Rule 15c3-5 requires, among other things, that a broker-dealer with market access document its system of risk management controls and supervisory procedures that are designed to manage the financial, regulatory, and other risks of market access. The broker-dealer must preserve a copy of its supervisory procedures and “*a written description of its risk management controls*” as part of its books and records for the time period required by Exchange Act Rule 17a-4(e)(7) (emphasis added).<sup>7</sup> The required written description is intended, among other things, to assist SEC and SRO staff to assess the broker-dealer’s compliance with the Rule.<sup>8</sup>
21. During the Review Period, NYSE Arca Equities Rule 6.18(a) required, among other things, that every ETP Holder supervise persons associated with it to ensure compliance with federal securities laws and the Constitution or the Rules of the Exchange. NYSE Arca Equities Rule 6.18(b) required each ETP Holder to “establish and maintain a system to supervise the activities of its associated persons and the operation of its business[,]” and that such system “must be reasonably designed to ensure compliance with applicable federal securities laws and regulations and NYSE Arca Equities Rules.” Moreover, NYSE Arca Equities Rule 6.18(c) required each ETP Holder to “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 achieve compliance with applicable federal securities laws and regulations with the NYSE Arca Equities Rules.”
22. During the Review Period, NYSE Arca Equities Rule 2010 provided that ETP Holders, in the conduct of their business, shall observe high standards of commercial honor and just and equitable principles of trade.

### **Interactive Brokers’ Systems**

23. During the Review Period, Interactive Brokers was a significant market access provider, acting as the gateway to U.S. securities markets and executing nearly 1 million trades per day for its Market Access Customers.

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<sup>7</sup> See 17 C.F.R. § 240.15c3-5(b). Rule 17a-4(e)(7) requires a broker-dealer to maintain and preserve such description “until three years after the termination of the use of” the document. See 17 C.F.R. § 240.17a-4(e)(7).

<sup>8</sup> Exchange Act Release No. 34-63241, 75 Fed. Reg. 69792, 69812 (Nov. 15, 2010).

24. During the Review Period, all Interactive Brokers customer orders were entered into the Firm's gateway to the Firm's order management and routing systems. The Firm's order management and routing systems then applied certain rate-limit filters to all incoming orders. The orders were then checked against a number of credit and capital criteria, and if the orders passed these criteria, they were sent to the Firm's order routing system.
25. The order routing system applied certain pre-trade controls prior to routing an order to a market center, including price, size/quantity, and anti-wash-trade controls. The order routing system then routed customer orders to the appropriate market center(s) via the Firm's exchange gateways, which applied an additional layer of filters, including price, size/quantity and rate limits.<sup>9</sup>

### **Pre-Trade Erroneous Order Controls**

26. Notwithstanding the pre-trade controls the Firm had during the Review Period, in multiple instances during this approximately four and one-half year period, Interactive Brokers failed to prevent the transmission of erroneous customer equity orders to the SROs due to inadequate risk management controls and supervisory procedures, resulting in 81 CEE events on 64 trade dates, including 71 CEEs filed on the Exchange.

#### *Pre-trade Price Controls*

27. Although the Firm implemented a number of pre-trade price controls to prevent the entry of erroneous orders during the Review Period,<sup>10</sup> the Firm's pre-trade price controls were inadequate. For instance, of the 81 CEEs, at least 38 were more than 10% away from the market at the time of order entry.
28. There were several primary deficiencies in the Firm's pre-trade price controls. First, prior to April 2014, Interactive Brokers did not have any pre-trade price control for orders entered outside of regular market hours when typically there is no last sale or National Best Bid and Offer "NBBO" to use as a reference price. In addition, prior to November 2014, there were gaps in the application of the Firm's pre-trade price controls outside of regular trading hours. In fact, 73 of the 81 CEEs at issue in this matter were executed outside of regular market hours, the majority in excess of 15% away from the prevailing market.
29. For example, on May 14, 2013, the Firm's controls did not prevent the entry of at least four orders pre-open that were more than 50% away from the prior closing price of \$25.87. The Firm's customer erroneously entered orders pegged to both sides of the

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<sup>9</sup> The exchange gateways also prevent the entry of orders that exceed a maximum gross value of all orders they expect to execute on a particular market based on historical transaction levels.

<sup>10</sup> The controls were designed to cap orders to a price within a certain percentage or distance of the current market, *i.e.*, generally, the last sale and/or National Best Bid and Offer.

market with a range of \$12.91-\$12.94; there was no prevailing market at the time so the Firm's pre-trade price controls did not reject the entry of the orders or cap their prices. When the market opened, the orders were paired off against each other at the erroneous prices, resulting in the filing of CEEs and the trades being busted.

30. Second, the Firm's pre-trade price controls as designed did not reasonably prevent, on an order by order basis, the entry of erroneous orders to the market. The Firm's pre-trade price controls re-price or "cap" limit orders to prices that are within a certain percentage of the current market or prior close based upon defined parameters<sup>11</sup> and submit such orders to an exchange or alternative trading system. However, the Firm did not provide a mechanism by which to ensure that a re-priced or capped order fit within a customer's intended limit price, by confirming with the customer whether the new price of the order was intended or acceptable and thus was not erroneous. As a result, the Firm's pre-trade price controls still permitted certain potentially erroneous orders to enter the market.
31. For example, on January 28, 2016, an Interactive Brokers customer intended to submit an order to purchase 100 shares of ABCD<sup>12</sup> at a limit price of \$559/share. However, the customer mistakenly entered a limit price of \$5,990. At the time the order was entered, the NBBO for ABCD was \$606.12 x \$606.99. Upon receipt of the order, the Firm's filter re-priced the order to buy at \$607.20/share without confirming with the customer whether the new price was intended or acceptable, and the order was then executed in full at a price above the customer's intended limit price.

#### *Pre-trade Size Controls*

32. In November 2012, the Firm implemented pre-trade size controls to prevent the entry of erroneous orders, which included an order size filter. However, during the Review Period, prior to August 2016, these pre-trade size controls were inadequate as the parameters for the order size filter were too wide to effectively prevent erroneously entered orders for securities that were not actively traded as the controls failed to take into account the individual characteristic of the securities, such as the average daily trade volume ("ADTV").

#### *Written Supervisory Procedures for Erroneous Orders*

33. In addition, through at least December 31, 2014, the Firm's written supervisory procedures failed to provide for the supervisory steps and reviews to be taken by the appropriate supervisor when conducting reviews of the Firm's pre-trade price or size controls to prevent the entry of erroneous orders.

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<sup>11</sup> The Firm's pre-trade price controls do not re-price or cap orders to prices that are inferior to the limit price the customer entered.

<sup>12</sup> A generic identifier has been used in place of the name of this security.

34. The acts, practices, and conduct described above in paragraphs 23 through 33 constitute violations of Exchange Act Rules 15c3-5(b) and (c)(1)(ii), and NYSE Arca Equities Rules 6.18 and 2010.

### **Supervision of Customer Trading**

35. At various points during the Review Period Interactive Brokers implemented a series of post-trade surveillance reports and reviews to monitor customer trading activity to detect and prevent potentially violative or manipulative trading activity, including for wash trades, pre-arranged trading, layering<sup>13</sup> or spoofing,<sup>14</sup> marking the close, insider trading, and MOC/LOC activity. However, the Firm failed to adequately supervise its customers' trading to detect and prevent certain kinds of potentially violative activity over a span of approximately two and one-half years.
36. There were several identified deficiencies with certain of the Firm's surveillance reports and reviews. First, prior to July 30, 2015, the Firm had no specific, dedicated surveillance reports or reviews specifically designed to detect unusual patterns of cancellations, including spoofing or layering. For example, between August 2013 and October 2014, potentially violative spoofing activity was identified to have occurred in 10 symbols over 9 trade dates involving a combination of illiquid securities, execution prices away from the NBBO, odd-lot orders and executions, and round-trips that left the initial buyer flat.<sup>15</sup>
37. In addition, as of December 31, 2015, the Firm did not have any surveillance reports or reviews, such as an ADTV filter, specifically designed to detect unusual price and/or volume activity in thinly traded securities which could be indicative of manipulative trading. For example, Staff reviewed 32 instances of potential pre-arranged trading between a Firm customer located in China and two customers of another broker-dealer in 5 symbols, on 4 trade dates in July and August 2013. The trades appeared coordinated, with the Firm's customer consistently entering hidden orders in illiquid securities during the post-core trading session, at unusually high or low prices outside the ranges

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<sup>13</sup> Layering is a manipulative trading tactic designed to induce other market participants into executing trades at artificial prices. Layering generally involves, but is not limited to, a pattern in which multiple, non-bona fide (*i.e.* not intended to be executed) limit orders are entered on one side of the market in a stock at various price levels, which creates the appearance of a change in the supply and demand of the security, thereby moving the price. At or around the same time, the trader enters one or more orders for execution on the opposite side of the market; upon execution of some or all of those orders (in full or in part), any open non-bona fide orders are immediately cancelled. The activity is often then repeated on the opposite side of the market.

<sup>14</sup> Spoofing is also a manipulative trading tactic designed to induce other market participants into executing trades at artificial prices. Spoofing generally involves, but is not limited to, a trading pattern in which multiple, non-bona fide limit orders are entered, thereby triggering some type of market movement and/or response from another market participant, combined with the entry of one or more orders for execution on the opposite side of the market. Upon execution of some or all of those orders, any open non-bona fide orders are cancelled.

<sup>15</sup> Because the Exchange lacked jurisdiction over the individual persons or entities responsible for the underlying trading activity, Staff referred all of the conduct to the SEC for further review.



observed during core sessions, in close proximity with orders entered by the other participants. The Firm's systems did not detect this activity.

38. Finally, as of December 31, 2015, the Firm's marking the close surveillance was deficient. The Firm's surveillance detected executions in thinly traded stocks within the last 20 minutes of a security's close over rolling periods of days. However, because the surveillance was designed to detect only patterns of potential marking activity and was not designed to also capture instances of such activity on key individual trade dates (*e.g.*, month-end, quarter-end, year-end, etc.), the Firm's surveillance was inadequate.
39. For example, a Firm customer appeared to engage in potential marking the close activity in the same security on two month-end dates, June 30, 2015, and July 31, 2015, without detection by the Firm. In the first instance, the customer's trading in the last 10 minutes of the day accounted for more than 95% of the volume in the security and moved the price approximately 2.64%. In the second instance, the customer's trading in the last 10 minutes of the day accounted for more than 69% of the volume in the security and moved the price approximately 8.9%.
40. The acts, practices, and conduct described above in paragraphs 35 through 39 constitute violations of Exchange Act Rules 15c3-5(b) and (c)(2), and NYSE Arca Equities Rules 6.18 and 2010.

## **ORDER**

Interactive Brokers LLC violated:

Violated Exchange Act Rules 15c3-5(b) and (c)(1)(ii), and NYSE Arca Equities Rules 6.18 and 2010, by failing to establish, document, and maintain a system of risk management controls and supervisory procedures, including written supervisory procedures and an adequate system of follow-up and review, reasonably designed to manage the financial, regulatory, and other risks of its market access business, including pre-trade controls to prevent the entry of erroneous orders by rejecting orders that exceed appropriate price or size parameters.

Violated Exchange Act Rules 15c3-5(b) and (c)(2), and NYSE Arca Equities Rules 6.18 and 2010, by failing to establish, document, and maintain a system of risk management controls and supervisory procedures, including written supervisory procedures and an adequate system of follow-up and review, reasonably designed to manage the financial, regulatory, and other risks of its market access business to ensure compliance with all regulatory requirements, including supervising customer trading to detect and prevent potentially violative activity.

## SANCTIONS

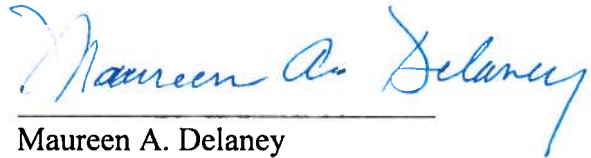
Interactive Brokers LLC is censured and fined \$230,000.<sup>16</sup>

Interactive Brokers LLC is also ordered to address the Market Access Rule deficiencies described in this Decision to ensure that it has implemented controls and procedures that are reasonably designed to achieve compliance with the rules and regulations cited herein.

Within 90 days this Decision, a registered principal of Interactive Brokers LLC shall submit to the COMPLIANCE ASSISTANT, Legal Section, Market Regulation Department, 9509 Key West Avenue, Rockville, MD 20850, a written report, certified by a senior management Firm executive, to [MarketRegulationComp@finra.org](mailto:MarketRegulationComp@finra.org), providing the following information:

- A reference to this matter;
- A representation that the Firm has addressed the deficiencies described in connection with this Decision; and
- The date this was completed.<sup>17</sup>

These sanctions are effective immediately.



Maureen A. Delaney  
Chief Hearing Officer

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<sup>16</sup> Under the Offer of Settlement and Consent, the Firm agreed to pay a total fine of \$450,000, of which \$230,000 shall be paid to NYSE Arca and the remaining amount shall be paid to Bats BZX Exchange, Inc., Bats EDGA Exchange, Inc., Bats EDGX Exchange, Inc., and NASDAQ Stock Market LLC in accordance with the terms of parallel settlement agreements in related matters between Interactive Brokers LLC and each of these self-regulatory organizations.

<sup>17</sup> The Department of Market Regulation may, upon a showing of good cause and in its sole discretion, extend the time for compliance with these provisions.