

NYSE ARCA, INC.

NYSE REGULATION,

Complainant,

v.

CUTLER GROUP, LP,

Respondent.

Proceeding No. 2018-07-00013

February 13, 2019

Cutler Group, LP violated: (i) Securities Exchange Act of 1934 Rule 15c3-5(b) and (c)(1)(ii), by failing to establish, document, and maintain controls and procedures reasonably designed to prevent and detect the entry of erroneous quotes into the market; and (ii) NYSE Arca Rule 11.18(b) and (c), by failing to establish and maintain a supervisory system and written supervisory procedures reasonably designed to ensure compliance with the Market Access Rule. Consent to censure and \$10,000 fine.

Appearances

For the Complainant: Tony Frouge, Esq. and Ross Schwarz, Esq., NYSE Regulation.

For the Respondent: Doug Patterson, for Cutler Group, LP.

DECISION

Cutler Group, LP (“Cutler” or “Firm”) and NYSE Arca, Inc. (“NYSE Arca”) 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.¹ The Hearing Officer accepts the Offer of Settlement and Consent and issues this Decision in accordance with NYSE Arca rules.²

¹ 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 American LLC (f.k.a. NYSE MKT LLC), and FINRA.

² The facts, allegations, and conclusions contained in this Decision were taken from the executed Offer of Settlement and Consent.

FINDINGS OF FACTS AND VIOLATIONS

Overview

1. From at least January 1, 2018 through August 8, 2018 (“Relevant Period”), Cutler violated: (i) Rule 15c3-5(b) and (c)(1)(ii) (“Market Access Rule”) of the Securities Exchange Act of 1934 (“Exchange Act”), by failing to establish, document, and maintain controls and procedures reasonably designed to prevent and detect the entry of erroneous options quotes into the market; and (ii) NYSE Arca Rule 11.18(b) and (c), by failing to establish and maintain a supervisory system and written supervisory procedures (“WSPs”) reasonably designed to ensure compliance with the Market Access Rule. As discussed below, these violations relate to Cutler’s: (i) failures to test certain script changes in a trial environment and to require a system restart after making such changes; and (ii) use of an unreasonably restrictive excessive quoting post-trade surveillance.

Background and Jurisdiction

2. Cutler registered as an Options Trading Permit (“OTP”) Firm with NYSE Arca on April 4, 1994. Its principal place of business is in San Francisco, California.

Violations

Market Access Rule

3. Under Exchange Act Rule 15c3-5(b), “[a] broker or dealer with market access, or that provides a customer or any other person with access to an exchange or alternative trading system through use of its market participant identifier or otherwise, shall establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of this business activity.”
4. More specifically, under Exchange Act Rule 15c3-5(c)(1)(ii), “[t]he risk management controls and supervisory procedures required by paragraph (b) . . . shall be reasonably designed to systematically limit the financial exposure of the broker or dealer that could arise as a result of market access, including being reasonably designed to . . . [p]revent the entry of erroneous orders, by rejecting 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.”
5. During the Relevant Period, Cutler maintained certain risk management controls and supervisory procedures to prevent the entry of erroneous options quotes. Among other things, the Firm’s risk management controls and supervisory procedures included separate message controls for each symbol on each of the three options quoting platforms the Firm used, including a third party vendor platform. Cutler’s risk management controls and supervisory procedures also required a trader and the Firm to take certain steps

before changing a script that the Firm did not already use, know or trust (including testing that script and quoting logic in a trial environment to make sure it worked upon initialization).

6. However, Cutler's risk management controls and supervisory procedures did *not* require testing a script change in a trial environment if the Firm already used, knew, or trusted the script, nor did they require a quoting system restart for script changes made on an intraday basis.
7. On July 14, 2018, a market maker at Cutler quoting in symbol WXYZ made intraday changes (here, a spread increase) to a script the Firm had used previously. Therefore, the script change and freeze logic did not need to be tested in a trial environment or require a system restart. But after making the change, the freeze logic failed to initialize and perform as intended when the script was activated at the opening of the market on July 14, 2018.³ As a result of this failure, during a span of 79 seconds that morning, the Firm submitted over 2.1 million messages across underlying series in WXYZ. The Firm's erroneous messaging activity did not, however, impact WXYZ as it did not result in any executions.⁴
8. Notwithstanding the lack of market impact, it was unreasonable for Cutler to not have risk management controls and supervisory procedures in place to: (i) test a script change in a trial environment, even if that change was to a script the Firm already used, knew, or trusted; and (ii) require a quoting system restart after the Firm made script changes on an intraday basis. For this reason, Cutler violated Exchange Act Rule 15c3-5(b) and (c)(1)(ii).

Supervision

9. Under NYSE Arca Rule 11.18(b), OTP Firms must establish and maintain supervisory systems that are "reasonably designed to ensure compliance with applicable federal securities laws and regulations and NYSE Arca Rules."
10. Also, under NYSE Arca Rule 11.18(c), OTP Firms must establish, maintain, and enforce WSPs that are "reasonably designed to ensure compliance with applicable federal securities laws and regulations, and with the NYSE Arca Rules."
11. As discussed above, Cutler did not have supervisory systems or WSPs in place to test script changes in a trial environment if the change was to a script the Firm already used, knew or trusted. In addition, nothing in Cutler's procedures or WSPs required the Firm to

³ Had the Firm required at least a system restart upon a minor script change, it would have prevented initialization failures like the one that occurred here. A restart validates the changes and ensures proper initialization.

⁴ Analysis did not uncover any market impact with respect to trading in WXYZ options or the underlying equity as a result of the erroneous quotes at issue here.

test script changes under such circumstances or to restart the quoting system to ensure that all script logic initialized properly.

12. As a result, Cutler's supervisory system and WSPs were not reasonably designed to ensure compliance with Exchange Act Rule 15c3-5(b) and (c)(1)(ii). For this reason, Cutler violated NYSE Arca Rule 11.18(b) and (c) during the Relevant Period.
13. Cutler also violated NYSE Arca's supervisory rules during the Relevant Period because the Firm's daily T+1 high-frequency quoting post-trade report ("T+1 Erroneous Quoting Report") was not reasonably designed to detect potential excessive quoting for supervisory review.
14. The Firm's T+1 Erroneous Quoting Report only identified quoting activity for review when the number of messages for a particular series in a symbol generated more than 50,000 messages over the course of an entire trading day. However, excessive quoting under 50,000 messages could occur over time periods far less than one trading day—for example, over the span of one second or five seconds—and such quoting activity could have an impact on NYSE Arca and market participants. Thus, Cutler violated NYSE Arca Rule 11.18(b) and (c) during the Relevant Period for this reason as well.

Relevant Disciplinary History

15. On March 28, 2014, Cutler consented to a censure and a fine of \$155,000 for violations of Exchange Act Rule 15c3-5(b) and (c) and NYSE Arca Options Rule 11.18(b) and (c), by failing to have: (i) system parameters, surveillance, and WSPs to prevent and detect potential wash sales; and (ii) WSPs and operational risk control systems reasonably designed concerning the oversight and operation of algorithmic quoting and trading.⁵

Other Factors

16. In resolving the matter, NYSE Regulation took into account that Cutler voluntarily and quickly undertook to improve its risk management controls, supervisory systems and WSPs for preventing and detecting erroneous quotes into the market, including: implementing upgraded platform software that contains additional features concerning script changes and freeze logic; updating the Firm's procedures requiring any intraday script change be accompanied by a quoting system restart (which applies to minor script changes as well, thereby addressing potential initialization failures like occurred here); and substantially lowering the parameters of the Firm's daily T+1 Erroneous Quoting Report in order to capture more exceptions for review where potential excessive quoting occurs over a much shorter span of time. NYSE Regulation also took into account Cutler's extensive cooperation with the investigation.

⁵ In connection with these NYSE Arca matters, Cutler also consented to a censure and a fine of \$230,000 payable to Nasdaq OMX PHLX for the same violations.

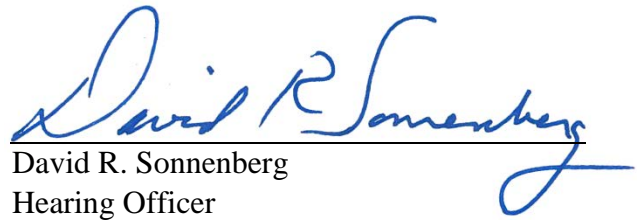
ORDER

Cutler violated: (i) Exchange Act Rule 15c3-5(b) and (c)(1)(ii), by failing to establish, document and maintain controls and procedures reasonably designed to prevent and detect the entry of erroneous quotes into the market; and (ii) NYSE Arca Rule 11.18(b) and (c), by failing to establish and maintain a supervisory system and WSPs reasonably designed to ensure compliance with the Market Access Rule.

SANCTIONS

Cutler Group, LP is censured and fined \$10,000.

These sanctions are effective immediately.


David R. Sonnenberg
Hearing Officer