

**RULE ENFORCEMENT REVIEW  
OF THE  
KANSAS CITY BOARD OF TRADE**



**Division of Market Oversight  
February 26, 2003**

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# **RULE ENFORCEMENT REVIEW OF THE KANSAS CITY BOARD OF TRADE**

## **I. INTRODUCTION**

The Division of Market Oversight (“Division”) has completed a rule enforcement review of the self-regulatory programs at the Kansas City Board of Trade (“KCBT” or “Exchange”) for compliance with applicable core principles under Section 5(d) of the Commodity Exchange Act (“Act”) and Part 38 of the Commission’s regulations.<sup>1</sup> The Division’s review covered core principles that relate to the Exchange’s audit trail, trade practice surveillance, disciplinary, and dispute resolution programs. The Division also reviewed KCBT’s compliance with core principles relating to exchange governance. The review covers the period of June 1, 2001 through June 1, 2002 (“target period”).<sup>2</sup>

Specifically, the Division evaluated Exchange compliance with eight core principles. Core Principle 10– Trade Information and Core Principle 17- Recordkeeping, relate to the maintenance of an audit trail that can be used to assist a contract market in the identification and prosecution of customer and market abuses and the maintenance of trade-related records. Core Principle 2- Compliance with Rules and Core Principle 12- Protection of Market Participants, relate to surveillance, enforcement, and disciplinary procedures used by a contract market to

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<sup>1</sup> Rule enforcement reviews prepared by the Division are intended to present an analysis of an exchange’s overall compliance capabilities for the period under review. Such reviews deal only with programs directly addressed in the review and do not assess all programs. The Division’s analyses, conclusions, and recommendations are based, in large part, upon the Division’s evaluation of a sample of investigation and disciplinary case files, and other exchange documents. This evaluation process, in some instances, identifies specific deficiencies in particular exchange investigations or methods but is not designed to uncover all instances in which an exchange does not address effectively all exchange rule violations or other deficiencies. Neither is such a review intended to go beyond the quality of the exchange’s self-regulatory systems to include direct surveillance of the market, although some direct testing is performed as a measure of quality control.

<sup>2</sup> The Division last rule enforcement review of the Exchange was presented to the Commission on September 15, 2000 (“2000 Review”).

protect market participants from abusive trading practices. Core Principle 13- Dispute Resolution, relates to fair and equitable dispute resolution procedures for customers and member-to-member disputes. The Division also focused on Core Principle 14- Governance Fitness Standards; Core Principle 15- Conflicts of Interest; and Core Principle 16- Composition of Boards of Mutually Owned Contract Markets, which relate to exchange governance.<sup>3</sup>

To assess KCBT compliance with these core principles, Division staff reviewed Exchange rules and numerous documents used by the Exchange's Department of Audits and Investigations ("A&I") in performing its routine oversight responsibilities. These documents included, among other things, computer reports and other documentation used routinely for audit trail enforcement and trade practice surveillance; audit trail recordkeeping and trade practice investigation files; trading cards and order tickets from selected firms for selected dates; trade practice investigation, floor surveillance, and disciplinary logs; disciplinary case files; minutes of disciplinary committee and Board of Directors ("Board") meetings held during the target period; and compliance manuals and guidelines. The Division also interviewed A&I officials with respect to the operation of the Exchange's self-regulatory programs.<sup>4</sup>

The Division provided the Exchange an opportunity to review and comment on a draft of this report on February 10, 2003. On February 12, 2003, Division staff conducted an exit conference with KCBT officials to discuss the report's findings and recommendations.

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<sup>3</sup> Appendix B to Part 38 of the Commission's regulations provides guidance concerning the core principles with which a designated contract market must comply to maintain its designation. In addition, Appendix B provides acceptable practices for several of the core principles. Although the acceptable practices establish non-exclusive safe harbors, they do not establish a mandatory means of compliance with the core principles. Appendix B provides acceptable practices for Core Principles 2, 10, 13, and 17. However, acceptable practices are not set forth for Core Principles 12, 14, 15, or 16. In promulgating Part 38, the Commission reserved the authority to adopt acceptable practices for Core Principles 12, 14, 15, and 16 at a later date.

<sup>4</sup> A copy of the July 24, 2002 transcript of the interview can be found in Appendix 1.

## **II. SUMMARY OF FINDINGS AND RECOMMENDATIONS**

### **A. Audit Trail Program**

#### **Findings**

- The Exchange maintains an adequate audit trail program that provides for the recording and safe storage of trade information in a manner that allows staff to use the information to assist in the prevention of customer and market abuses and to provide evidence of rule violations.
- Members manually record the time of execution for each trade to the minute on trading cards and order tickets. The Exchange maintained a high trade timing accuracy rate of approximately 93 percent during the target period.
- A&I staff reviews daily trade timing errors identified on computer reports and compiles monthly statistics of each member's trade timing errors. Members with a high monthly trade timing error rate are scheduled for an investigation.
- The Exchange's audit trail enforcement program also includes quarterly audit trail reviews of clearing firms and floor members to assess compliance with order ticket and trading card recordkeeping requirements. Reviews conducted during the target period indicate a high level of compliance with KCBT's trade recordation requirements.

**The Division has no recommendations in this area.**

### **B. Trade Practice Surveillance Program**

#### **Findings**

- The Exchange maintains an adequate trade practice surveillance program. Potential trade practice violations are identified through the use of computerized surveillance, daily review of computer reports, floor surveillance, and routine TPIs.
- The Exchange's investigations were completed in a timely manner and most investigations were thorough and well documented. Since the 2000 Review, the Exchange has improved the quality of its investigation reports by providing a complete and clear explanation to support its findings.
- The Division identified two investigations that it believes should have been expanded to include a more thorough analysis. In one investigation, in view of the member's previous involvement in noncompetitive trading, the Exchange should have looked beyond the recordkeeping aspect of the investigation to examine whether substantive violations may have occurred. In the second investigation, the Exchange should have expanded the scope of its investigation to include additional trade dates given the subject members' disciplinary histories.

## **Recommendations**

- **The Exchange should examine audit trail violations detected during the course of an investigation to determine whether such violations may have facilitated substantive trading abuses, especially in those instances in which the number of audit trail violations is large and/or the subject member has previously engaged in illegal trading activity.**
- **The Exchange should consider a member's prior disciplinary history when developing the scope of an investigation and increase the amount of trading activity examined beyond that reviewed in routine trade practice investigations.**

### **C. Disciplinary Program**

#### **Findings**

- The Exchange maintains an adequate disciplinary program. During the target period, five cases were referred for disciplinary action. The cases were all resolved in a timely manner pursuant to settlement agreements.
- The Exchange levied fines against five individuals totaling \$4,375. Two individuals were fined a total of \$2,500 for engaging in noncompetitive trading and one individual was fined \$500 for taking the opposite side of a customer's order. Neither case involved customer harm. The remaining \$1,375 in fines were imposed for recordkeeping violations.
- A&I issued 24 reminder and eight warning letters, principally for trading card recordkeeping violations.

**The Division has no recommendations in this area.**

### **D. Dispute Resolution**

#### **Findings**

- Customers are afforded voluntary dispute resolution through Exchange customer arbitration rules that are fair and equitable. A customer may elect to have his or her claim or grievance against a member or its employees heard by either a panel of the Arbitration Committee or by a specially constituted panel which has at least a majority of panel members who are not Exchange members or associated with any member of any designated contract market or employee thereof.
- Each party has the right to counsel and each party receives adequate notice of claims presented against them and an opportunity to be heard on all claims, defenses, and counterclaims. The Exchange's arbitration procedures require a prompt hearing and authorize prompt, written, final settlement awards that are not subject to appeal within the Exchange.

- Arbitration procedures also are provided for member-to-member disputes. Any member who commences any legal action against another member for any dispute must first attempt to arbitrate under Exchange rules or be subject to disciplinary action. In addition, member-to-member arbitration is separate from and independent of customer claims or grievances submitted for resolution.
- There were no customer or member-to-member arbitrations during the target period.

**The Division has no recommendations in this area.**

## **E. Exchange Governance**

### **Findings**

- A person with a significant history of disciplinary violations within the past three years, or a person who is currently suspended from trading on a contract market or is suspended or expelled from membership in any self-regulatory organization, is prohibited from serving on the Board or a disciplinary committee.
- The Exchange has adopted and enforces appropriate rules and procedures to identify and resolve the presence of conflicts of interest in any Board or disciplinary committee decision-making process.
- Prior to considering or hearing a matter that may involve a possible conflict of interest, Board members and members of disciplinary committees must disclose the possibility of such conflict. If A&I determines that a conflict exists, the person may not participate in deliberations, unless the person has unique expertise or is needed for a quorum, and may not vote on the matter.
- KCBT's Board fairly represents the diversity of interests of market users. During the target period, the Board included three futures commission merchants ("FCMs"), three commercials, three Wheat floor traders, one Wheat floor broker, one Wheat option floor trader, and one Value Line floor trader.

**The Division has no recommendations in this area.**

### III. AUDIT TRAIL PROGRAM

#### **Core Principle 10 – Trade Information:**

**The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables the contract market to use the information for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market.**

#### **Core Principle 17 – Recordkeeping**

**The board of trade shall maintain records of all activities related to the business of the contract market in a form and manner acceptable to the Commission for a period of five years.**

Pursuant to the acceptable practices set forth in Appendix B to Part 38 of the Commission's regulations, an effective contract market audit trail should capture and retain sufficient trade-related information to permit contract market staff to detect trading abuses and reconstruct transactions within a reasonable period of time. In addition, the contract market must create and maintain an electronic transaction history database that contains information with respect to transactions executed on the designated contract market. An acceptable audit trail also must be able to track a customer order from time of receipt through fill allocation or other disposition. Further, an acceptable audit trail should include original source documents, transaction history, electronic analysis capability and safe storage capability.

Original source documents include unalterable, sequentially identified records on which trade execution information is originally recorded, whether recorded manually or electronically. A transaction history consists of an electronic history of each transaction, including all data that are input into the trade entry or matching system for the transaction to match and clear. These data should include the categories of participants for whom such trades are executed; timing and sequencing data adequate to reconstruct trading; and the identification of each account to which fills are allocated. An electronic analysis capability permits sorting and presenting data included



in the transaction history so as to reconstruct trading and to identify possible trading violations, while safe storage capability provides for a method of storing the data included in the transaction history in a manner that protects the data from unauthorized alteration, accidental erasure or other loss.

Commission Regulation 1.31 governs the manner in which an exchange is required to maintain trade-related records. The regulation mandates that all records required to be kept under the Act or Commission regulations be maintained for five years and be readily accessible during the first two years. Most categories of required records may be stored on either micrographic or electronic storage media for the full five-year maintenance period. However, trading cards, documents on which trade information is originally recorded in writing, and order tickets must be retained in hard copy for five years.

#### **A. Trade Recordation Requirements**

AT KCBT, orders are either written-up on floor order tickets by clearing firm staff or electronically received at firm trading floor desks via the Trade Order Processing System (“TOPS”), an industry-wide order routing system.<sup>5</sup> Order tickets are then physically handed to floor brokers or order instructions are “flashed into the pit. Upon execution, a floor broker either records fill information on the order ticket or flashes fill information back to the firm’s desk. The Exchange requires that an order ticket include an account identifier, an order number, an entry timestamp indicating when the order was received on the floor, and an exit timestamp indicating when the filled order was returned or reported back to a firm’s desk.<sup>6</sup>

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<sup>5</sup> Nine of the Exchange’s 19 clearing firms receive orders via TOPS. Each of these firms has a TOPS machine at its trading floor desk that prints orders received from various office locations in the form of an order ticket.

<sup>6</sup> KCBT Resolution 11-1130.00-1.

KCBT also requires each member to record all trade executions for customer and personal accounts on trading cards promptly upon the purchase or sale of any contract.<sup>7</sup> Floor members record trades on double-sided cards, with buys on one side and sells on the other. The card must contain the member's trading initials, clearing firm code, date, time of trade execution to the nearest minute, quantity, commodity, month, price, opposite member and clearing firm initials, and for option contracts, premium, strike price, and put or call indicator. Members must record their trades in non-erasable ink, in sequential order, and without skipping lines between trades. In addition, a line must be drawn to separate trades executed during the opening and closing periods from other trades.

Three different types of trading cards are used at the Exchange: (1) personal trading cards; (2) brokerage cards; and (3) master cards. Personal trading cards, which are used by Exchange members to record personal trades, are pre-printed with the respective member's trading initials and card sequence numbers. Members must mark through any remaining unused lines on a personal trading card before starting a new card. Brokerage cards, which do not contain pre-printed sequence numbers, are used to record executions for house and customer accounts. A broker uses a separate brokerage card for each clearing member for which he or she fills customer orders. Finally, a broker also may record all house and customer fills together on a master card and then have the required trade information transcribed onto separate brokerage cards, one per clearing member. Master cards are used by brokers who fill orders for numerous clearing members and prefer not to carry or hold separate cards for each firm. Only two brokers used master cards during the target period.

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<sup>7</sup> KCBT Rule 1115.00.

Personal trading cards and brokerage cards must be submitted to clearing firms no later than 15 minutes after each 30-minute trading interval and promptly timestamped upon collection.<sup>8</sup> Clearing firms must submit trades to the Kansas City Board of Trade Clearing Corporation (“Clearing Corporation”) within 60 minutes after each 30-minute interval. The clearing system matches trades that agree on quantity, brokers, month, price, and clearing firms as soon as both sides are entered. Clearing firms can enter trades and correct errors until the first reconciliation report listing all matched trades is distributed, approximately 45 minutes after the close of each contract. In addition to the reconciliation report, clearing firms are given a list of trades that cannot be matched due to a data inconsistency (“cutout trades”). The Clearing Corporation busts all cutout trades that are not resolved by 4:00 p.m., the end of the final reconciliation process. However, cutout trades that are busted may be resolved prior to the opening on the following business day “as of” the original trade date.

The Clearing Corporation provides A&I with a “Daily Out-Trade Audit Report” (“Outtrade Report”) that contains a record of all cutout trades, corrections, and busted trades from the previous trading day. A&I reviews this report daily to ensure that trade corrections were not made to facilitate a trading abuse.<sup>9</sup> A&I also reviews all as-of trades by comparing the trade price to the previous day’s Time and Sales Report (“Time and Sales”).

## **B. Audit Trail Reviews**

The Exchange conducts quarterly reviews of order tickets and trading cards (“audit trail reviews”) to enforce its trade recordation requirements. Audit trail reviews alternate between

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<sup>8</sup> KCBT Rule 1115.02. Master cards are not subject to Exchange collection requirements because only data recorded on personal trading cards and brokerage cards are entered into the clearing system. However, pursuant to Commission Regulation 1.31, members who use master cards must save the cards for five years and produce the cards upon request.

<sup>9</sup> During the target period, one investigation, SP0110, arose from A&I’s review of the Outtrade Report. *See* pp. 21-22 for a discussion of this investigation.

full-scope and limited-scope reviews. Full scope reviews are intended to encompass all Exchange clearing firms and floor members.<sup>10</sup> Limited-scope reviews primarily focus on clearing firms and floor members who received a reminder or warning letter, or were referred to the Complaint Committee in the previous full-scope audit trail review.

For both full scope and limited scope reviews, A&I randomly selects a three-day period and examines all trading cards and order tickets prepared by the firms and floor members under review. If A&I finds that a clearing firm's or floor member's noncompliance rate exceeds five percent of the transactions examined, A&I will issue a reminder letter or a warning letter, or refer the matter to the Complaint Committee for possible disciplinary action.<sup>11</sup>

During the target period, A&I conducted two full-scope audit trail reviews in which it examined a total of 2,705 order tickets prepared by 13 clearing firms and 3,061 trading cards (1,732 brokerage cards and 1,329 personal trading cards) prepared by 68 floor members.<sup>12</sup> Overall, the reviews indicated a high level of compliance with KCBT's trade recordation requirements. A&I found that all of the order tickets examined contained order numbers and account identifiers; 2,652 of the order tickets (98 percent) included both entry and exit timestamps; and 2,999 of the trading cards (98 percent) were promptly timestamped upon collection.

With respect to floor members' brokerage and personal trading cards, the reviews indicated that all of the 3,061 trading cards were written in non-erasable ink. Further, 99 percent

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<sup>10</sup> When the Exchange initiates an audit trail review, one review is opened to examine clearing firms and a separate review is opened to examine floor members.

<sup>11</sup> The Exchange's program for enforcing its order ticket and trading card rules (as well as its trade timing rules) permits A&I to exercise discretion in determining whether to issue a reminder letter or a warning letter, or to refer a member to the Complaint Committee. For a first offense, A&I generally issues a reminder letter if a member's deficiency level is between five and ten percent, or a warning letter if the member's deficiency level exceeds ten percent. A second offense for the same violation(s) within one year generally results in a warning letter. A&I will refer members who repeatedly violate the Exchange's audit trail rules to the Complaint Committee.

<sup>12</sup> Copies of the investigation reports for the two audit trail reviews can be found in Appendix 2.

of the cards had all trades recorded in sequence, had no skipped lines, properly identified the opening and closing periods, and included the date, commodity, price, quantity, and put or call indicator for option trades. Additionally, 98 percent of the cards indicated the executing and opposite clearing firms, and 97 percent of the cards were collected by the clearing member within 15 minutes of each 30-minute trading interval. With respect to the additional requirements for personal trading cards, 99 percent of the 1,329 personal trading cards reviewed were preprinted with members' trading initials and trading card sequence numbers, and had unused lines properly marked through. In addition, 98 percent of the personal trading cards were properly started after each 30-minute trading interval.

The Division's examination of the Exchange's audit trail reviews found that the reviews were thorough, well documented, and completed in a timely manner. The Exchange's files included copies of all original floor orders and personal trading cards examined during the respective review, worksheets, and copies of all resulting reminder and warning letters. Each audit trail review file also included a form that showed the start date, completion date, final report date, and the dates of any resulting disciplinary actions, as well as the dates of any further action taken by a disciplinary committee.

### **C. Trade Timing**

As stated above, KCBT requires that the buying and selling members manually record the time of each trade to the nearest minute on his or her trading card. The Exchange enforces this requirement by reviewing its daily trade register, the Time Audit Report ("TAR"), which contains various codes indicating possible trade timing errors.<sup>13</sup> The Exchange's one-minute

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<sup>13</sup> A sample copy of the TAR can be found in Appendix 3.

trade timing accuracy rate, as computed for all contracts on two representative trade dates for each month of the target period, was a high 93 percent.

The TAR identifies seven types of timing errors that may be indicative of a trade timing violation. The first error is “Bought Side-No Trade” (“B-NT”). The TAR compares the time recorded by the buyer to the Time and Sales listing. If no trade is indicated on Time and Sales at the time recorded by the buyer, or within one minute preceding or one minute following that time, the trade is coded B-NT. The second error is “Sold Side-No Trade” (“S-NT”). The computer program follows the same procedure as for a B-NT, but compares the seller’s recorded time to the prices recorded on Time and Sales. The third error, “No Quotes at This Price” (“No Quote”), is a combination of a B-NT and a S-NT. Thus, a trade is coded as a No Quote if the trade does not appear on Time and Sales within a minute of the time recorded by either the buyer or the seller.

The fourth type of timing error identified on the TAR is “Time Out of Limits” (“TOL”). A trade is coded TOL if the times recorded by both the buyer and the seller are marked as accurate by the system but there is more than two minutes between the two times. The fifth error noted on the TAR is “Bought Side-Untimed Trade” (“B-UT”). A trade is coded B-UT if the buyer fails to record a time for the trade on his or her trading card. Similarly, a trade is coded as “Sold Side-Untimed Trade” (“S-UT”) if the seller fails to record a time for a trade on his or her trading card. The final timing error, “Invalid Spread,” refers to a spread differential that does not appear on Time and Sales within the minute or minute preceding or following the trade time recorded by either the buyer or seller.

A&I reviews the TAR daily and compiles monthly statistics of each member’s timing errors. Although members are not summarily disciplined based on these statistics, members with

a high error rate are scheduled for a routine trade practice investigation (“TPI”).<sup>14</sup> As part of the routine TPI, A&I collects the member’s trading records for the time period under review and examines all trade timing errors (and potential trade practice violations) identified on the TAR for the particular member. If A&I finds that the member’s trade timing deficiency level exceeded five percent of his or her transactions, A&I will issue either a reminder or a warning letter, or refer the member to the Complaint Committee for possible disciplinary action.

**D. Safe Storage Capability**

KCBT trade data and historical files are stored and maintained in an AS 400 computer system. Trade data also are periodically backed-up throughout each trading day and saved to tape. These data are then restored to a back-up AS 400 computer system periodically throughout the day. Therefore, at the end of each trading day, all trade data and historical files are maintained in two different AS 400 computer systems, as well as on tapes. The tapes are removed from the Exchange’s premises nightly. The Exchange retains trade information for a time period that exceeds the five years required by Commission Regulation 1.31.

**E. Conclusions and Recommendations**

The Division found that the Exchange maintains an adequate audit trail program. Pursuant to Core Principle 10, the Exchange maintains rules and procedures that provide for the recording and safe storage of trade data, time and sales data, and historical transactions in a manner that enables A&I to use the information to assist in the prevention of customer and market abuses and to provide evidence of any rule violations. The Exchange’s program for enforcing its audit trail rules allows staff to reconstruct the path of a customer order from the

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<sup>14</sup> A routine TPI is a review of a member’s trading activity for potential trade violations over a three-to five-day time period. See pp. 19-20 for a discussion of the Exchange’s routine TPI program.

time of receipt to fill allocation or other disposition. In addition, the Exchange retains audit trail data for at least five years in compliance with Core Principle 17.

The Division's review of one-minute trade execution times recorded by members during the target period found that the Exchange's overall accuracy rate was a high 93 percent. A&I daily reviews trade timing errors identified on the TAR and compiles monthly statistics of each member's timing errors. Those members with a high trade timing error rate typically are scheduled for a routine TPI.

The Exchange's audit trail enforcement program also includes quarterly audit trail reviews of clearing firms and floor members to assess compliance with order ticket and trading card trade recordation requirements. The Division's review of the Exchange's full-scope audit trail reviews found that clearing firms and floor members demonstrated a high level of compliance with pertinent Exchange rules. In addition, the Exchange's audit trail reviews were thorough, well documented, and completed in a timely manner.

Based on the foregoing, the Division has no recommendations in this area.



#### IV. TRADE PRACTICE SURVEILLANCE PROGRAM

##### **Core Principle 2 – Compliance with Rules:**

**The board of trade shall monitor and enforce compliance with rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.**

##### **Core Principle 12 – Protection of Market Participants:**

**The board of trade shall establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants.**

Pursuant to Appendix B to Part 38 of the Commission's regulations, a contract market's trade practice surveillance program should have the arrangements, resources, and authority necessary to perform effective rule enforcement. The arrangements and resources attendant to the program should facilitate the direct supervision of the contract market, including analysis of relevant data. An acceptable program should have systems that maintain all data reflecting the details of each transaction executed on the contract market. In this regard, the program should include routine electronic analysis of these data to detect potential trading violations. The program also should provide for appropriate and thorough investigation of all potential trading violations brought to the contract market's attention, including member and Commission referrals and customer complaints. In addition, the program should have the authority to discipline, suspend, or terminate the activities of members or market participants pursuant to clear and fair standards.<sup>15</sup>

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<sup>15</sup> That aspect of Core Principle 2 which relates to the disciplining of members who violate Exchange rules is discussed below in Section V, Disciplinary Program. This section of the report addresses the Exchange's program for monitoring its markets for possible trading abuses and the investigation of any abuses identified.

## **A. Compliance Staff**

A&I is responsible for administering the Exchange's trade practice surveillance and audit trail programs.<sup>16</sup> A&I's staff is comprised of two individuals who monitor and review all aspects of Exchange trading activity. They also conduct trade practice investigations and audit trail reviews. These two individuals, each of whom has served in his current position for the past five years, are the Vice President and Assistant Vice President for Compliance. The Vice President has 15 years of Exchange experience and the Assistant Vice President has 12 years of Exchange experience. The Assistant Vice President is primarily responsible for monitoring the Wheat futures contract and the Vice President is primarily responsible for monitoring the Wheat options contract and the Value Line futures and options contracts. Although A&I staff is small, the Division believes staffing levels are sufficient to monitor the limited number of markets currently trading at the Exchange.<sup>17</sup> In addition, staff has not encountered problems with completing investigations in a timely manner.

## **B. Automated Surveillance System**

The TAR also serves as the Exchange's automated trade practice surveillance system.<sup>18</sup> The system identifies possible trade practice violations by performing edit functions based on predetermined parameters designed for specific types of trading abuses. All trades meeting the criteria for one or more parameters are flagged as exceptions on the TAR with a violation code. The codes relate to violations such as trading ahead of customer orders, accommodation trading,

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<sup>16</sup> A&I also administers the Exchange's market and financial surveillance programs.

<sup>17</sup> The Exchange lists contracts in Wheat and Value Line futures and options. Internet Stock Index futures and options were delisted as of January 28, 2003. In 2002, KCBT volume was 3,326,836 contracts, with virtually all of the volume in Wheat futures and options.

<sup>18</sup> A separate TAR is generated for each Exchange-traded contract. As discussed earlier at pp. 11-13, the TAR also identifies possible trade timing errors.

wash trading, and money passing. The system identifies all cross trades, which are referred to as “ring trades” at KCBT.<sup>19</sup>

A&I reviews the TAR daily for each contract and conducts an initial inquiry into each trade identified as a possible violation in order to determine whether to open a formal investigation. A formal investigation is typically opened if further information and more detailed analyses are needed to determine whether a rule violation occurred, or if a particular member has an unusually high number of exceptions on a given day or during a given month. For example, with respect to possible wash trades and accommodation trades, A&I’s initial inquiry considers factors such as the price difference between the trades, the amount of time between the trades, the price movement during that time, and the number of contracts traded. When necessary, A&I also requests trading cards and order tickets and/or discusses the questionable trade(s) with the member(s) involved.

The Division selected six days over the course of the target period to examine A&I’s daily TAR reviews with respect to trade practice violations. The Division found that A&I adequately reviewed all flagged trades and that pertinent information reflecting staff’s initial analysis regarding such trades was recorded on the respective TAR. During the target period, two investigations arose from A&I’s daily TAR reviews. Both involved improper ring trades and resulted in two members being issued reminder letters. In addition, an investigation involving taking the opposite side of a customer order that was opened prior to the target period and completed during the target period resulted in a \$500 fine against one member.<sup>20</sup>

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<sup>19</sup> A&I manually reviews all ring trades to ensure that they were executed in accordance with Exchange rules.

<sup>20</sup> Investigations SP0203 and SP0205 involved improper ring trades, and Investigation SP0104 involved taking the other side of a customer order.

### **C. Floor Surveillance**

A&I conducts daily floor surveillance on the open and close in each market, and randomly during the day for a 15- to 20-minute time period.<sup>21</sup> If a market is exceptionally active or volatile, A&I staff will stay on the floor longer, typically until the activity abates.

Observations made during daily floor surveillance may result in a more targeted analysis of a member's trading activity during A&I's daily TAR review and can result in the opening of an investigation. Similarly, if A&I has reason to believe that a member is engaging in prohibited trading activity, it will closely monitor the member's trading activity while on the floor to enhance an ongoing investigation.

The Exchange maintains a daily floor surveillance log for each contract.<sup>22</sup> The log reflects the observer's initials, data and time of surveillance, and any material observations. If a possible trading violation is observed, the observing staff member prepares a "Floor Surveillance Report" and notes this on the floor surveillance log. Floor Surveillance Reports list the following information: (1) the date and time of the observation; (2) the staff member who observed the incident; (3) the member or firm observed; (4) the possible violation; (5) any prior instances of similar conduct; (6) the action taken, including summaries of any conversations between A&I staff and members related to the incident; and (7) an investigation number if the matter is examined further.

During the target period, A&I prepared two Floor Surveillance Reports, one of which resulted in an investigation after staff observed a noncompetitive trade between two members after the close of the Wheat futures contract. Based upon the investigation's findings, the two

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<sup>21</sup> Due to the higher trading volume in Wheat futures and options, both A&I staff members observe the opening and closing periods for these contracts.

<sup>22</sup> A copy of the floor surveillance log can be found in Appendix 4.

members were referred for disciplinary action and pursuant to settlement agreements, were fined \$2,000 and \$500, respectively. A&I prepared the second Floor Surveillance Report after observing a floor clerk, who also is an Exchange member, trade opposite his firm's primary floor broker while on the telephone. A&I verbally reminded the floor clerk of the relevant rules regarding taking the other side of an order and the use of telephones in the trading pit.<sup>23</sup>

#### **D. Routine TPIs and Special Investigations**

The Exchange also conducts routine TPIs and Special Investigations to monitor trading activity for possible abuses. A routine TPI is a comprehensive examination of a member's trading activity for possible rule violations, typically over a three- to five-day period. A&I generally examines 300 trades for members trading Wheat futures and options, and 100 trades for members trading Value Line futures and options. The Exchange strives to perform one routine TPI on each active member during the calendar year.

During a routine TPI, A&I reviews all of a member's trades executed during the designated review period. In this connection, A&I runs a report from the TAR to isolate the member's possible timing errors and trade practice violations and requests relevant trading cards and order tickets. A&I then analyzes all of the possible errors and violations and reviews the order tickets and trading cards for recordkeeping compliance. Finally, A&I meets with the member under review to discuss possible violations that remain unresolved after staff have completed their analyses. If A&I concludes that a reasonable basis exists, it will issue a reminder or warning letter, or refer the matter to the Complaint Committee for consideration of charges, depending upon the severity of the violation.

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<sup>23</sup> KCBT Rules 1133.00 (Taking Other Side) and 1177.00 (Prohibition On Use Of Telephones). KCBT Rule 1177.00 prohibits brokers from being in a pit with a telephone in hand or from executing trades in the pit with a telephone in hand.

In addition to routine TPIs, the Exchange conducts Special Investigations when evidence indicates that a violation of Exchange rules may have occurred. Special Investigations generally are initiated from observations of unusual trading activity arising from floor surveillance, daily TAR reviews, Commission or National Futures Association (“NFA”) referrals, or investigation of member, customer, or anonymous complaints. The Exchange’s quarterly audit trail reviews also are classified as Special Investigations.<sup>24</sup>

During the target period, the Exchange opened a total of 41 investigations that included 29 routine TPIs and 12 Special Investigations. Of the 12 Special Investigations, two were initiated from A&I’s daily TAR review, one was initiated from A&I’s review of its Outtrade Report, one was initiated from floor surveillance, and the remaining eight were audit trail reviews.

The Division found that the Exchange’s investigations were completed in a timely manner. During the target period, the Exchange closed a total of 41 investigations, which included five investigations opened prior to the target period. Of the 41 investigations closed during the target period, 39 were completed within four months and two were completed within six months.<sup>25</sup>

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<sup>24</sup> A&I records information relating to each routine TPI or Special Investigation on the Exchange’s investigation log. The information recorded includes the investigation number, name(s) of the member(s) under investigation, the date the investigation was opened and closed, the name of the staff member conducting the investigation, the source of the investigation, and findings. If an investigation is referred for disciplinary action, the log will reflect the actions taken and the dates of such actions. A copy of the investigation log can be found in Appendix 5.

<sup>25</sup> The five investigations opened during the target period that remained open at the close of the target period have since been closed. All five investigations were completed within four months of their respective open date.

## **E. Adequacy of Investigations**

The Division conducted an in-depth review of 24 investigations (15 routine TPIs and nine Special Investigations) for adequacy and thoroughness.<sup>26</sup> The Division found that most of the Exchange's investigations were thorough and well documented. Each file included an index of its contents, a summary of the investigative steps taken (with the date each step was completed), spreadsheets, work papers, summaries of interviews, letters notifying the subject member of the investigation and its results, and a copy of the investigation report. The Division also found that the Exchange has improved the quality of its investigation reports by providing a clear and complete explanation to support its findings. Specifically, in those instances when A&I concluded that there was not a reasonable basis to conclude that a rule violation occurred, investigation reports stated why the facts not supportive of finding a rule violation outweighed facts supportive of such a finding.<sup>27</sup>

However, the Division found two investigations that it believes should have been expanded to include a more thorough analysis given the existence of audit trail violations that may have facilitated substantive trading abuses, and the subject members' previous disciplinary histories. The first investigation, Investigation SP0110, was opened after A&I identified a large number of outrades on four consecutive days involving one member.<sup>28</sup> The subject floor member was previously the subject of a Commission enforcement action relating to wash sales, fictitious sales, and noncompetitive trading at the Chicago Board of Trade.<sup>29</sup> KCBT's

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<sup>26</sup> The Division also reviewed the investigation reports for the remaining 17 investigations closed during the target period.

<sup>27</sup> In the previous rule enforcement review of the KCBT, dated September 15, 2000, the Division found that investigation reports did not always clearly explain how A&I concluded that there was no basis for finding a rule violation.

<sup>28</sup> A copy of the investigation report for Investigation SP0110 can be found in Appendix 6.

<sup>29</sup> In March 2001, the Commission denied the member's motion to reduce sanctions. The member was fined \$5,000 and his trading privileges were suspended for six months.

investigation revealed that the member failed to record a time for 29 trades and the opposite clearing member for 20 trades. Further, of the 53 trading cards A&I examined, eight cards reflected more than one trade on a line, giving the appearance that trades possibly were not recorded in chronological order of execution. In addition, four of the cards reflected trades that occurred on the open or close but were not identified as such, and unused lines were not properly marked through on any of the 53 trading cards. Finally, none of the cards included preprinted trading initials. The member was issued a warning letter for his recordkeeping violations.

The Division notes that the Exchange's investigation focused solely on the number of audit trail violations committed by the member and included no analysis regarding whether the audit trail violations or the outrades may have been associated with noncompetitive trading. Trading card violations, such as those uncovered in this investigation, and missing trade times, can be indicative of substantive trading violations. The Division believes that the Exchange should have looked beyond the recordkeeping aspect of this investigation to examine whether substantive violations may have occurred, especially in view of the member's previous involvement in noncompetitive trading,

The second investigation, Investigation W0118, involves possible accommodation trading identified during the course of a routine TPI.<sup>30</sup> The TPI covered four days of trading for the subject member and found a possible accommodation trade between that member and another member, both of whom were previously sanctioned by the Exchange for noncompetitive trading and other substantive trading violations. A&I concluded that the evidence did not support a finding of a rule violation. Toward that end, the investigation report noted that A&I's floor surveillance experience and daily TAR reviews did not reveal "any pattern of

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<sup>30</sup> A copy of the investigation report for Investigation W0118 can be found in Appendix 7.



accommodation trading between the members.” The member who was the subject of the TPI was fined \$250 for trading card violations.

Based on the members’ previous disciplinary histories, the Division believes that the Exchange should have expanded its review of trading between the two members beyond four days. In this connection, in 1999, the Exchange fined both members \$250 for engaging together in noncompetitive trading.<sup>31</sup> In May 2000, Division staff observed what it believed to be another occurrence of noncompetitive trading between the two members and referred the matter to the Exchange. Upon investigation, the Exchange fined one of the members \$2,500 for disclosing orders and taking the opposite side of a customer’s order.<sup>32</sup> In addition, during the target period, the other member was fined \$2,000 for noncompetitive trading and for taking the other side of a customer order, and \$1,000 for failing to report trades and failing to time trades to the nearest minute.<sup>33</sup>

## **F. Conclusions and Recommendations**

The Division found that the Exchange maintains an adequate trade practice surveillance program. Although A&I only has a staff of two, these individuals have extensive Exchange experience and are able to monitor adequately the limited number of markets traded at the

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<sup>31</sup> Investigation SP9907. Both members were charged with violating KCBT Rule 1110.00 (Trades Executed Openly and Competitively), KCBT Rule 1132.00 (Disclosure of Orders), KCBT Rule 1133.00 (Taking Other Side), and KCBT Rule 1134.00 (Prearranged Sale). The Division reviewed this case in the 2000 Review and found that the imposed penalty was insufficient in light of the activity involved.

<sup>32</sup> Investigation SP0002. Division staff observed one of the members receive a verbal customer order from a firm floor clerk to buy 30 July Wheat futures at the market. The member waved off the order and tapped the other member on the shoulder and directed his attention to the floor clerk. The floor clerk then verbally gave the order to the other member. Both members then turned to face each other and recorded the trade without it first being offered to the pit. As a result, the first member took the opposite side of his customer’s order. A&I obtained the relevant trading records and interviewed both members and the floor clerk. The first member was referred for disciplinary action and was charged with violating KCBT Rule 1132.00 (Disclosure of Orders) and KCBT Rule 1133.00 (Taking Other Side). A&I concluded, however, that there was insufficient evidence to refer the second member for disciplinary action.

<sup>33</sup> Investigation SP0204 (noncompetitive trading and trading ahead of customer orders) and Investigation W0120 (audit trail violations). Prior to Investigation W0120, the member had been issued two reminder letters, two warning letters, and had been fined a total of \$1,000 in two separate matters for audit trail violations.

Exchange. The Exchange's investigations were completed in a timely manner and were well documented. In addition, the Exchange's investigations were generally conducted in a thorough manner. The Exchange also improved the quality of its investigation reports by providing a clear and complete explanation to support its findings.

The Division, however, found two investigations that it believes should have been expanded to include a more thorough analysis given the existence of audit trail violations that may have facilitated substantive trading abuses, and the subject members' previous disciplinary histories. In one investigation, the Exchange should have analyzed whether audit trail violations were associated with substantive trading abuses. In the second investigation, the Exchange should have expanded the scope of its investigation to include additional trade dates.<sup>34</sup>

Based on the foregoing, the Division recommends that the Exchange:

- **Examine audit trail violations detected during the course of an investigation to determine whether such violations may have facilitated noncompetitive trading, especially in those instances in which the number of audit trail violations is large and/or the subject member has previously engaged in illegal trading activity.**
- **Consider a member's prior disciplinary history when developing the scope of an investigation and increase the amount of trading activity examined beyond that reviewed in routine trade practice investigations.**

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<sup>34</sup> At the exit conference held with Exchange staff to discuss the Division's findings and recommendations, the Division requested that the Exchange reopen the investigations and advise the Division of its findings upon completion.

## V. DISCIPLINARY PROGRAM

### Core Principle 2 – Compliance with Rules:

**The board of trade shall monitor and enforce compliance with rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.**

As noted earlier, Core Principle 2 requires, among other things, that an exchange have the authority to discipline, suspend, or terminate the activities of members or market participants pursuant to clear and fair standards. Consequently, an acceptable compliance program should provide for prompt and effective disciplinary action for any violation that is found to have been committed.

#### A. Disciplinary Committees and Procedures

The Complaint Committee and the Business Conduct Committee (“BCC”) serve as the Exchange’s two primary disciplinary committees. The Complaint Committee consists of ten members representing various Exchange interests who are appointed each year by the Chairman of the Exchange and approved by the Board of Directors.<sup>35</sup> The BCC consists of five members, three of whom are elected, the First Vice Chairman of the Exchange and the President of the Clearing Corporation.<sup>36</sup> The elected members serve for a three-year staggered term so that each year one new member is elected to replace the elected member who has served three years.

The Complaint Committee is a grand jury-type committee that reviews investigation reports referred by A&I to determine whether a Notice of Charges should be issued.<sup>37</sup> In this regard, the Complaint Committee must meet within ten business days of receipt of an

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<sup>35</sup> KCBT Rule 247.00.

<sup>36</sup> KCBT Rule 244.00.

<sup>37</sup> KCBT Rules 1410.00 and 1414.00.

investigation report to consider the matter.<sup>38</sup> Exchange policy requires that the Complaint Committee determine one of the following: (1) additional investigation or evidence is necessary, (2) no reasonable basis exists for finding a violation, (3) a reasonable basis exists for finding a violation, but prosecution is not warranted,<sup>39</sup> or (4) a reasonable basis exists for finding a violation and the matter should proceed for adjudication to the BCC for hearing.

If the Complaint Committee determines that formal charges should be issued, A&I staff will prepare a Notice of Charges.<sup>40</sup> A Notice of Charges must include a summary of the possible violations, the possible rules that have been violated, and the options available to the charged party. Those options include filing a written answer within ten business days either admitting or denying the charges, or filing a “nolo contendere” plea. A failure by the charged party to file a written answer within the prescribed time period will be deemed as a not guilty plea and a hearing will be scheduled.<sup>41</sup> Upon being served with a Notice of Charges, the charged party has the right to be represented by counsel in all succeeding stages of the disciplinary proceeding.<sup>42</sup>

The Complaint Committee receives and considers all settlement offers. If the Complaint Committee accepts a settlement offer, the offer is then forwarded to the BCC for final acceptance and approval.<sup>43</sup> The BCC must consider a settlement offer within ten business days of receipt from the Complaint Committee.<sup>44</sup> If the BCC rejects a settlement offer, a full hearing on the

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<sup>38</sup> KCBT Rule 1412.00.

<sup>39</sup> If the Complaint Committee finds that there was a violation but prosecution is not warranted, it generally will issue a warning letter. The Complaint Committee did not issue any warning letters during the target period. All such letters sent during the target period were issued by A&I staff.

<sup>40</sup> KCBT Rule 1414.00.

<sup>41</sup> KCBT Rule 1414.02. A nolo contendere plea is neither an admission nor denial of guilt, but has the effect of a member waiving all proceedings except a hearing, if necessary, to set appropriate penalties. KCBT Rule 1414.02(f).

<sup>42</sup> KCBT Rule 1425.00(a).

<sup>43</sup> KCBT Rule 1416.00.

<sup>44</sup> KCBT Rule 1417.00.

matter will be scheduled either before the entire BCC or a panel of the BCC.<sup>45</sup> The BCC is required under most circumstances to issue a written decision within 15 business days.<sup>46</sup> A decision of the BCC may be appealed to the Board within ten business days. The Board or a panel of the Board is required to hear the appeal within 20 business days and to issue a written decision within 30 calendar days of the hearing.<sup>47</sup>

## **B. Sanctions Imposed**

Five cases were referred to the Complaint Committee for disciplinary action and subsequently settled during the target period.<sup>48</sup> Three of the cases involved audit trail violations and the remaining two cases involved trade practice violations that included indirectly taking the opposite side of customer orders and failure to openly and competitively execute trades. The Exchange levied sanctions totaling \$4,375 against five members. Although \$4,375 is a small amount of fines for a 12-month period, the Division has identified no systemic deficiencies in the Exchange's trade practice program that would suggest that the Exchange should have brought additional cases during the target period.

One member was the subject of two disciplinary actions as a result of two separate investigations, Investigations W0120 and SP0204.<sup>49</sup> In Investigation W0120, the member was charged with failing to report trades and to accurately and legibly time trades to the nearest minute. The member was fined \$1,000.<sup>50</sup> In Investigation SP0204, the same member was

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<sup>45</sup> KCBT Rules 1417.01 and 1421.00. No hearings were held during the target period.

<sup>46</sup> KCBT Rule 1432.01.

<sup>47</sup> KCBT Rules 1437.00 and 1442.00.

<sup>48</sup> One case involved two members and one member was a subject in two different cases.

<sup>49</sup> Although separate matters, these two cases were referred to the Complaint Committee together on March 28, 2002. A copy of the investigation reports for Investigations W0120 and SP0204 can be found in Appendix 8.

<sup>50</sup> In connection with this matter, the member also received an A&I staff warning letter regarding 15 brokerage cards for which he failed to record the clearing member code, three personal trading cards for which he failed to

charged with failing to trade openly and competitively and taking the opposite side of a customer's order. A second member was also charged with noncompetitive trading in this matter. The matter emanated from floor surveillance after A&I staff observed the members record two Wheat trades on their trading cards after the close, resulting in one member taking the opposite side of two lots of his customer's three-lot order. A&I did not observe the trades take place in the pit.<sup>51</sup> Based on the fill received, which was within the closing range, there did not appear to be customer harm. The members were fined \$2,000 and \$500, respectively.

The other substantive violation that resulted in a sanction involved a member who took the opposite side of two lots of his customer's 55-lot Wheat options order. There was no customer harm, as the customer received his limit price. The member was fined \$500. The remaining sanctions levied during the target period included \$175 and \$200 fines against two members for various trading card recordkeeping violations.<sup>52</sup> A&I also issued 24 reminder letters and eight warning letters regarding trade timing and recordkeeping violations, and one reminder letter concerning the Exchange's rule requiring that all orders be executed openly and competitively.<sup>53</sup>

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mark through remaining blank lines, and two brokerage and two personal trading cards that were not submitted to the clearing member within 15 minutes following the end of a 30-minute interval.

<sup>51</sup> A&I noted that one member was in the July area of the Wheat pit and the other was in the May area with his back to the July area during the entire closing period. After the 1:15 closing bell, one member approached the other and both members turned their backs to A&I staff. The members engaged in brief discussion and then both proceeded to record trade information on their trading cards. The Wheat TAR for that date showed that two trades timed at 1:14 cleared between the two members.

<sup>52</sup> Investigations SP0104, W0116, and W0118, respectively. Copies of the investigation reports for Investigations SP0104 and W0116 can be found in Appendix 9. A copy of the investigation report for Investigation W0118 can be found in Appendix 7.

<sup>53</sup> With respect to the reminder letter for open and competitive execution of orders, A&I had received an anonymous complaint regarding Wheat options trading. A&I investigated whether a particular member had violated KCBT Rules 1136.00 (Withholding or Withdrawal of Orders) and 1110.00 (Trades Executed Openly and Competitively). After reviewing trading records and interviewing several members present in the pit when the alleged noncompetitive trades were executed, A&I did not find sufficient evidence to support a rule violation. Investigation SP0105.

### **C. Timeliness of Disciplinary Procedures**

The Division found that the Complaint Committee reviewed investigation reports promptly after receiving them. Exchange rules require that the Complaint Committee meet within ten business days of receiving an investigation report to consider the report, and determine whether to issue a notice of charges within ten business days of the respective meeting.<sup>54</sup>

The Complaint Committee met four times during the target period to review five investigation reports. In each instance, the Complaint Committee met within ten business days of receiving an investigation report to consider the report, reached its decision on the day of the meeting, decided to issue a Notice of Charges, and issued such notice within ten business days following the meeting. All of the respondents submitted settlement offers within 14 days, and those offers were reviewed and accepted by both the Complaint Committee and the BCC within 20 days of their submission

### **D. Conclusion**

Based upon its review, the Division found that the Exchange maintains an adequate disciplinary program. During the target period, a total of five cases involving audit trail and trade practice rule violations were reviewed by the Complaint Committee. All five cases were settled and resulted in fines totaling \$4,375 against five individuals. In addition, A&I issued 24 reminder letters and eight warning letters, principally for trading card recordkeeping violations. All disciplinary matters referred to the Complaint Committee during the target period were

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<sup>54</sup> KCBT Rules 1412.00 and 1413.00.

considered in a timely manner. In addition, all settlement offers were timely accepted and approved by the Complaint Committee and the BCC.

Based on the foregoing, the Division has no recommendations in this area.



## **VI. DISPUTE RESOLUTION**

### **Core Principle 13 – Dispute Resolution**

**The board of trade shall establish and enforce rules regarding and provide facilities for alternative dispute resolution as appropriate for market participants and any market intermediaries.**

Pursuant to the acceptable practices set forth in Appendix B to Part 38, an exchange is required to provide a customer dispute resolution mechanism that is fundamentally fair and equitable, and available on a voluntary basis. In this regard, customers should have the opportunity to have their claims heard and decided by an objective and impartial decision maker. Each party should have the right to counsel and be provided with adequate notice of claims presented against him or her and an opportunity to be heard on all claims, defenses, and counterclaims. The process also should provide for the opportunity of a prompt hearing. An exchange's dispute resolution mechanism should authorize prompt, written, final settlement awards that are not subject to appeal within the exchange. The parties also should be notified of the fees and costs that may be assessed. If an exchange provides procedures for the resolution of member-to-member disputes (not involving customers), the procedures for resolving such disputes must be independent of and not interfere with the resolution of customers' claims or grievances.

#### **A. Customer Arbitration**

KCBT customers are afforded voluntary dispute resolution through the Exchange's customer arbitration rules and procedures. A customer may elect to have his or her claim or grievance against a member or its employees heard by either a panel of the Exchange's Arbitration Committee or by a specially constituted panel which has at least a majority of panel

members who are not Exchange members or associated with any member of any designated contract market or employee thereof.<sup>55</sup>

Any customer desiring to submit a matter in dispute for arbitration must file a written sworn complaint alleging the nature of the dispute, the basic facts, the damages sought, and the name of the member within one year after the date of the transaction from which the dispute arose. If the member fails to answer the complaint in writing within ten days, or fails to sign an agreement to arbitrate, the member will be deemed as refusing to arbitrate and incurs the possibility of disciplinary action by the BCC, including an award for the customer.<sup>56</sup> A member also has the right to file counterclaims that arise out of the transaction or occurrence that is the subject of the customer's claim or grievance. The customer must reply to the counterclaim within ten days.<sup>57</sup>

Arbitration proceedings are held at the KCBT, unless otherwise agreed to by the parties, and are required to take place in a timely manner. Each party has the right to be represented by counsel at its own expense. Each party also is entitled to appear in person or by telephone conference at the arbitration hearing unless the claims submitted are less than \$2,500, in which case the claim may be resolved without a hearing on the basis of submitted written documents.<sup>58</sup>

The hearing body must meet to discuss the case within two business days after the hearing and make its decision within ten business days after receipt of the transcript. The hearing body must render its award(s) or finding(s) within five business days after its decision.

There is no right of appeal to any entity within the KCBT to overturn the arbitration decision.

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<sup>55</sup> KCBT Rules 1500.00, 1503.00, 1503.01 and 1503.02. A customer also may elect to have his or her claim or grievance heard by a single arbitrator who meets the requirements of former Commission Regulation 180.2(a). KCBT Rule 1503.03.

<sup>56</sup> KCBT Rules 1510.00, 1510.01, 1514.00, and 1517.00.

<sup>57</sup> KCBT Rules 1524.00 and 1524.01.

<sup>58</sup> KCBT Rules 1528.00, 1528.01, 1528.02, 1528.03, 1529.00 and 1531.00.

The only right of appeal is under applicable law. A member's refusal to comply with an award within 30 calendar days of its issuance is a violation of KCBT Rules.<sup>59</sup>

Arbitration fees are initially paid by the party bringing the case. Those fees, and any additional incurred costs, are ultimately assessed against either of the parties in the case, as may be decided by the hearing body and included in its award or finding.<sup>60</sup> There were no customer arbitrations during the target period.

#### **B. Member-to-Member Arbitration**

The Exchange's member-to-member arbitration rules and procedures generally are similar to the customer arbitration rules. However, any member who commences legal action against another member for any dispute must first attempt to arbitrate under Exchange rules or be subject to Exchange disciplinary action. If arbitration has been attempted and rejected, then a legal action may be commenced and the member failing or refusing to arbitrate also may be subject to Exchange disciplinary action. Exchange rules also provide that member-to-member disputes involving futures contract transactions are independent of and separate from any customer claims or grievances submitted for dispute resolution.<sup>61</sup> There were no member-to-member arbitrations during the target period.

#### **C. Conclusion**

Based upon its review, the Division found that the Exchange maintains adequate dispute resolution procedures. KCBT rules provide customers with voluntary procedures for arbitration that are fundamentally fair and equitable. In this connection, customers have the opportunity to have their claims heard and decided by an objective and impartial decision maker. Each party

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<sup>59</sup> KCBT Rules 1541.00 through 1541.06.

<sup>60</sup> KCBT Rules 1548.00 and 1551.00.

<sup>61</sup> KCBT Rules 1600.00, 1603.00 and 1604.00.

has the right to counsel and each party receives adequate notice of claims presented against them and an opportunity to be heard on all claims, defenses, and counterclaims. The Exchange's arbitration procedures require a prompt hearing and authorize prompt, written, final settlement awards that are not subject to appeal within the Exchange. The Exchange also provides adequate arbitration procedures for member-to-member disputes. Any member who commences legal action against another member for any dispute must first attempt to arbitrate under Exchange rules or be subject to Exchange disciplinary action. In addition, member-to-member arbitration is separate from and independent of customer claims or grievances submitted for resolution. There were no customer or member-to-member arbitrations during the target period.

Based on the foregoing, the Division has no recommendations in this area.

## VII. GOVERNANCE

### Core Principle 14 – Governance Fitness Standards

**The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, and any other persons with direct access to the facility (including any persons affiliated with any of the persons in this paragraph).**

### Core Principle 15 – Conflicts of Interest:

**The board of trade shall establish and enforce rules to minimize conflicts of interest in the decision making process of the contract market and establish a process for resolving such conflicts of interest.**

### Core Principle 16 – Composition of Board of Mutually Owned Contract Markets:

**In the case of a mutually owned contract market, the board of trade shall ensure that the composition of the governing board reflects market participants.**

#### A. Fitness Standards

The Division believes that KCBT has established and enforces appropriate fitness standards for Exchange members, Board members, and members of the Exchange's disciplinary committees.<sup>62</sup> Any person or entity that wishes to become an Exchange member must submit a membership application.<sup>63</sup> Among other things, an applicant must submit a sworn statement answering questions regarding fitness standards.<sup>64</sup> For example, an applicant must provide information regarding his or her membership or denial of membership at any futures or securities exchange, his or her disciplinary history at any futures or securities exchange, and any judgments other than minor traffic violations. An applicant also must answer questions regarding finances.

A&I reviews membership applications to ensure that applicants meet minimum financial requirements. The Membership Committee is responsible for reviewing each membership

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<sup>62</sup> See pp. 25-27 for a description of the Exchange's disciplinary committees.

<sup>63</sup> See KCBT Rule 106.00.

<sup>64</sup> These fitness standards are the same as those enumerated under Section 8a(2) of the Act that would serve as a basis for refusal to register a person.

application and for recommending whether the Board should approve or disapprove an applicant. At least eight Board members must vote in the affirmative to approve an applicant as qualified for membership.<sup>65</sup> During the target period, no membership applications were disapproved. With respect to the ongoing fitness of Exchange members, NFA will notify the Exchange of any members whose registration has been suspended or revoked.

The Exchange prohibits a person with a significant history of disciplinary violations within the past three years, or a person who is currently suspended from trading on a contract market or is suspended or expelled from membership in any self-regulatory organization, from serving on the Board, Complaint Committee, BCC, or an Arbitration Panel.<sup>66</sup> For example, a person would be barred from service, if, among other things, he or she was found pursuant to a final decision to have committed a “disciplinary offense” or entered into a settlement agreement in which the findings or acts charged included a disciplinary offense. A disciplinary offense includes any violation of the rules of a self-regulatory organization, except those rules relating to decorum or attire, financial requirements, or reporting or recordkeeping requirements (provided that the resulting reporting or recordkeeping fines do not total more than \$5,000 within any calendar year), unless violation of such rules involved fraud, deceit, conversion, or resulted in a suspension or expulsion. The Exchange also deems any violation of the Act or the Commission’s regulations as a disciplinary offense.<sup>67</sup>

A&I monitors the fitness of persons with governing authority or who serve on a disciplinary committee to ensure that the individuals have not committed a disciplinary offense within the past three years. Prior to the Nominating Committee meeting each November to

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<sup>65</sup> KCBT Rules 130.00 and 131.00. All KCBT members have voting privileges.

<sup>66</sup> KCBT Rule 260.00.

<sup>67</sup> KCBT Rule 260.00(1).

prepare a list of candidates for elected positions and the Chairman appointing members to the standing committees the following January, A&I staff presents a list to the Assistant Secretary which reflects members who are ineligible to serve on the Board or a disciplinary committee. A&I also reviews fitness information on an ongoing basis throughout the year. During the target period, no member of the Board, the Complaint Committee, or the BCC was removed for failure to comply with KCBT's fitness requirements.

**B. Conflicts of Interest**

The Division's found that KCBT has adopted and enforces appropriate rules and procedures to identify and resolve the presence of conflicts of interest in any Board or disciplinary committee decision-making process. In addition, KCBT has adopted and enforces rules that limit the use or disclosure of material non-public information gained through the performance of official duties by Board members, committee members, and KCBT employees.

Specifically, the Exchange's rules describe what relationships will be considered a conflict of interest in matters involving named parties in interest and Board members or disciplinary committee members hearing such matters. The rules also provide procedures for resolving conflicts of interest.<sup>68</sup> In this regard, a member of the Board, Complaint Committee, or BCC must abstain from such body's deliberations and from voting on any matter where such member is: (1) a named party in interest or an employer, employee, or fellow employee of a named party in interest; (2) associated with a named party in interest through a broker association; (3) has any other significant, ongoing business relationship with a named party in

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<sup>68</sup> KCBT Rules 261.00, 1421.01 and 1438.01.

interest; (4) has a family relationship with a named party in interest; or (5) has a direct and substantial financial interest in the result of the vote.<sup>69</sup>

Determinations as to the nature of a relationship between a member of the Board or member of a disciplinary committee and a named party in interest are largely determined by, but are not limited to, the member's disclosure of such a relationship.<sup>70</sup> Similarly, determinations as to whether a Board member or member of the Complaint Committee or BCC has a direct and substantial financial interest are made based upon, but are not limited to, such member's disclosure of positions held in the member's personal accounts, proprietary accounts, and customer accounts.<sup>71</sup> In both instances, A&I will review such disclosures in addition to any other information reasonably available to determine if a conflict exists. During the target period, A&I was not asked to consider any potential conflicts of interest regarding any member of the Board or a disciplinary committee.

Board members, members of Exchange committees, and Exchange employees also are prohibited from disclosing material, non-public information obtained from the person's respective service in such position.<sup>72</sup> During the target period, there were no matters that involved the Exchange's non-disclosure rules.

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<sup>69</sup> In the event that a Board or committee member's participation in deliberations is necessary for achieving a quorum or the member has unique or special expertise, knowledge, or experience in a matter under consideration, the member may participate in deliberations prior to a vote, provided that such participation is consistent with the public interest and the member abstains from voting on such action. KCBT Rule 261.00(d).

<sup>70</sup> KCBT Rule 261.00(b)(2) requires that prior to the consideration of any matter involving a named party in interest, each member of the Board or disciplinary committee must disclose to A&I whether he or she has one of the above-mentioned relationships with a named party in interest.

<sup>71</sup> KCBT Rule 261.00(c)(3) and (4).

<sup>72</sup> KCBT Rules 232.031, 232.06, and 251.01.



### **C. Board Composition**

Finally, as described below, the Division believes that the composition of KCBT's Board adequately reflects a broad array of market participants to ensure that various interests are fairly represented. The Exchange's governing body includes the Chairman, First Vice Chairman, Second Vice Chairman, President, and Treasurer. These individuals also serve on the Exchange's Board, along with 12 Exchange members, four outside directors, the President of the KCBT Investment Company, the President of the Clearing Corporation, and the Secretary.<sup>73</sup>

The Exchange, which is a mutually owned Delaware for-profit corporation, requires that ten percent or more of the Board include persons representing farmers, producers, merchants or exporters of the principal commodities underlying a commodity futures or commodity option contract traded on the Exchange. In addition, the Board must represent a diversity of membership interests including floor brokers, floor traders, FCMs, producers, consumers, processors, distributors, and merchandisers of commodities traded on the Exchange, as well as participants in a variety of pits or principal groups of commodities traded on the Exchange.<sup>74</sup> During the target period, the Board's members included three FCMs, three commercials, three Wheat floor traders, one Wheat floor broker, one Wheat option floor trader, and one Value Line floor trader.

### **D. Conclusion**

The Division found that the Exchange has adopted and enforces appropriate rules and procedures that relate to Exchange governance. The Exchange has established membership procedures to ensure that members satisfy enumerated fitness standards. With respect to the

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<sup>73</sup> KCBT Rule 200.00. Under KCBT Rule 230.05, outside directors may not be Exchange members or employees, or officers, principals, or employees of a firm that holds an Exchange membership. In addition, outside directors must have knowledge of futures trading or financial regulation.

<sup>74</sup> KCBT Rules 210.01 and 210.02.

ongoing fitness of members, NFA notifies the Exchange of any members whose registration has been suspended or revoked. The Exchange also prohibits a person with a significant history of disciplinary violations within the past three years, or a person who is currently suspended from trading on a contract market or is suspended or expelled from membership in any self-regulatory organization, from serving on the Board or a disciplinary committee. A&I monitors the fitness of members of the Board, Complaint Committee, and BCC to enforce these standards.

With respect to conflicts of interest, prior to considering or hearing a matter that may involve a possible conflict of interest, members of the Board, Complaint Committee, and BCC are required to disclose the possibility of such conflict. If A&I determines that a conflict does exist, the person may not participate in deliberations, unless the person has a unique expertise or is needed for a quorum, and may not vote on the matter. Board members, members of Exchange committees, and Exchange employees also are prohibited from disclosing material, non-public information obtained from the person's respective service in such position. Lastly, the Exchange's Board fairly represents the diversity of interests of market users.

Based on the foregoing, the Division has no recommendations in this area.