RULE ENFORCEMENT REVIEW
OF THE
NEW YORK BOARD OF TRADE

Division of Market Oversight

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RULE ENFORCEMENT REVIEW
OF THE MARKET SURVEILLANCE PROGRAM
AT THE NEW YORK BOARD OF TRADE

I. INTRODUCTION

The Division of Market Oversight ("DMO") has completed a rule enforcement review of the market surveillance program of the New York Board of Trade ("NYBOT" or "Exchange") for compliance with applicable core principles under Section 5(d) of the Commodity Exchange Act ("Act"), as amended by the Commodity Futures Modernization Act of 2000 ("CFMA"), and Part 38 of the Commission's regulations. The review covers the target period of January 1, 2004 to December 31, 2004 ("target period").[1]

In June 1998, the New York Cotton Exchange ("NYCE") and its subsidiaries, the New York Futures Exchange and the Citrus Associates of NYCE, merged with the Coffee, Sugar, & Cocoa Exchange ("CSCE") to form the New York Board of Trade ("NYBOT"). Prior to June 10, 2004, NYBOT was composed of two subsidiaries, the CSCE (referred to as "Division A") and NYCE and its subsidiary exchanges (referred to as "Division B"). As of June 10, 2004, the exchanges officially became one exchange and NYBOT was designated as a contract market for all of its exchanges. However, the Exchange continues to maintain the Division A and Division B distinction for the purpose of conducting market surveillance.

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[1] Rule enforcement reviews prepared by DMO 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. DMO's analyses, conclusions, and recommendations are based, in large part, upon DMO'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.

The review focuses on the two core principles that relate to an exchange's market surveillance program. Core Principle 4, *Monitoring of Trading*, relates to an exchange's program to prevent manipulation, price distortion, and disruptions of the delivery or cash settlement process, and Core Principle 5, *Position Limitations or Accountability*, relates to an exchange's program for enforcing its speculative position limits and position accountability rules. Appendix B to Part 38 provides acceptable practices for demonstrating compliance with Core Principles 4 and 5.

For purposes of this review, DMO staff interviewed officials and staff from the Exchange's Market Surveillance Department ("MSD").[2] DMO also reviewed numerous documents used by MSD in carrying out the Exchange's routine market surveillance responsibilities. These documents included, among other things, the following:

- computer reports generated by the Exchange's automated surveillance systems and other documents used in market surveillance and speculative limit and position accountability enforcement;
- files and records concerning contract expirations, speculative limit and position accountability enforcement, and speculative limit exemptions;
- market surveillance inquiry, investigation, and disciplinary action files for cases closed or conducted during the target period;
- the Exchange's Market Surveillance Procedures Manuals and guidelines; and
- minutes of all Control Committee meetings and all other meetings of committees responsible for market surveillance matters held during the target period.

DMO provided the Exchange an opportunity to review and comment on a draft of this report on September 30, 2005. On October 11, 2005, DMO staff conducted an exit conference with Exchange officials to discuss the report's findings and recommendations.

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[2] A copy of the March 9, 2005 transcript of those interviews can be found in Appendix 1.

II. SUMMARY OF FINDINGS AND RECOMMENDATIONS

Findings

Market Surveillance Staff and Routine Surveillance

- The MSD's market surveillance activities are divided between NYBOT's former Division A and Division B exchanges. The Managing Director has primary responsibility for surveillance of the Division A markets and the Surveillance Manager has primary responsibility for surveillance of the Division B markets. They are assisted by six other MSD staff members. MSD staffing levels are adequate given the number of active NYBOT markets.

- Daily market surveillance activities include monitoring of prices, volume, open interest, spread relationships, market news, deliveries, physical supplies, and other factors that could affect NYBOT's markets.

Surveillance of Expiring Contracts

- Surveillance of expiring contracts is heightened well in advance of last trading day, focusing on position concentrations, large trader positions, deliverable supplies, and the relationship between open interest and deliverable supplies. Files maintained for contract expirations were well documented and reflective of the surveillance activities conducted.

- The December 2004 cotton contract was the only non-routine expiration during the target period. A major long position holder in the market indicated that he intended to take delivery on his large position during a tight supply situation. The Exchange's Control Committee and the MSD maintained close observation of the market and the MSD was in daily contact with the major long position holder. At expiration, the contract liquidated in an orderly manner.

Large Trader Reporting and Speculative Limit Enforcement

- The MSD uses two different computerized large trader reporting systems, one for its former Division A markets and one for its former Division B markets, to monitor compliance with speculative and hedge exemption position limits. Although both systems produce similar large trader reports, the Division B system has query capabilities that allow staff to sort data by a number of variables for both futures and options. The Exchange is working to merge the systems and have an integrated large trader reporting system incorporating the positive features of each system. The Exchange plans to have the new system operating by December 2005.

- Exemptions from speculative limits may be granted for bona fide hedging, arbitrage and straddle positions, and for independently controlled positions. DMO randomly reviewed 32 out of 93 position limit exemption requests filed during the target period and 22 letters confirming the renewal of overall and/or single month exemptions. The files examined were well documented, and indicated that exemption requests were thoroughly reviewed by the MSD and appear to be granted at appropriate levels.

- During the target period, eight investigations involving speculative limit violations were opened and closed. The investigations were thorough and completed in a timely manner. Violations were found in seven of the eight investigations, which resulted in five warning letters and three informational letters being issued to first time offenders.

Exchanges of Futures for Physicals and Exchanges of Futures for Swaps

- The Exchange conducts routine reviews of selected exchanges of futures for physicals ("EFPs") and exchanges of futures for swaps ("EFSs") monthly to ensure that they are transacted in accordance with Exchange rules. During the target period, the Exchange completed 12 reviews that examined 72 EFPs and two EFSs. In each review, the Exchange issued a document request letter that asked for, among other things, documentation that would verify the cash-side of the transaction. The Exchange's routine reviews were generally thorough and well-documented, and included appropriate analysis to determine whether the transactions satisfied the Exchange's EFP/EFS requirements.

- The Exchange opened 10 EFP investigations during the target period, nine resulting from DMO referrals and one from a routine review. The referrals identified EFPs which DMO believed involved either the same entity or affiliated entities under common control on both sides of the transaction.

- DMO's review of the investigations revealed that several of the investigations were not conducted in a thorough manner. DMO identified four EFP investigations where the Exchange did not issue document request letters to determine whether the EFPs were bona fide transactions satisfying all of the Exchange's requirements. Rather, the MSD only inquired as to whether the buyer and seller were under separate control.

- The Exchange's EFP investigations also revealed that NYBOT's requirement of separate control for affiliated entities may not be fully understood by members and their customers. Three of the five warning letters and both informational letters issued for EFP violations during the target period related to non-compliance with the Exchange's requirement that affiliated parties to an EFP be under separate control. In each case, it appeared that the subjects of the investigation were unaware of, or did not understand, the Exchange's rule in that regard.

<u>Recommendations</u>

- **The MSD should request underlying cash-side documentation for all EFPs under review, regardless of whether they emanate from a routine review or a Commission referral, to evaluate fully compliance with all provisions of the Exchange's EFP rule.**

- **The Exchange should issue a notice reminding members of the separate control requirement of NYBOT's EFP rule and how it can be satisfied, and request that members share this information with their customers who engage in EFPs.**

III. SURVEILLANCE OF MARKET ACTIVITY

Core Principle 4 – Monitoring of Trading:

The board of trade shall monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.

Core Principle 5 – Position Limitations or Accountability:

To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary and appropriate.

Pursuant to the acceptable practices set forth in Appendix B to Part 38 of the Commission's regulations, an acceptable market surveillance program should regularly collect and evaluate market data to determine whether markets are responding to the forces of supply and demand. An exchange also should have routine access to the positions and trading of its market participants. To diminish potential expiration problems that may arise from excessively large speculative positions, an exchange may need to establish speculative limits for some commodities. Such position limit rules may provide for hedge or other exemptions and the limits may be set differently by markets, delivery months, or time periods. Spot month limits should be adopted for markets based on commodities having more limited deliverable supplies or where necessary to minimize a market's susceptibility to manipulation or price distortion.

Position limits are not necessary for markets where the threat of excessive speculation or manipulation is very low. For some contracts, such as financial instruments, an exchange may provide for position accountability in lieu of position limits. An exchange which trades several products with a large number of traders should have an automated large trader reporting system that is used daily to enforce compliance with position limit rules.

A. Market Surveillance Staff and Overview of Routine Surveillance

The MSD, which is part of the Exchange's Market Regulation Department ("Market Regulation"), is responsible for administering the Exchange's market surveillance program.[3] MSD is led by the Managing Director, who reports to the Vice President of Market Regulation. MSD's staff includes a Surveillance Manager, a Senior Database Clerk, a Senior Database Clerk/Surveillance Assistant, an Exchange of Futures for Physicals ("EFP")/Operations Manager, an EFP/Operations Assistant, a Statistics Coordinator, and a Database Analyst.[4]

MSD's surveillance of NYBOT's markets is divided between the former Division A and Division B exchanges. The Managing Director has primary responsibility for surveillance of the Division A markets and the Surveillance Manager has primary responsibility for surveillance of the Division B markets.[5] Both conduct routine market surveillance activities, such as monitoring

[3] Market Regulation, which includes the MSD and the Compliance Department, reports to the Senior Vice President for Legal and Regulatory Affairs. The Senior Vice President for Legal and Regulatory Affairs also serves as NYBOT's General Counsel and Corporate Secretary.

[4] A copy of an organizational chart for MSD can be found in Appendix 2. The Vice President of Market Regulation has 24 years of experience in commodity regulation, including both market surveillance and trade practice surveillance. The Managing Director has 10 years of market surveillance experience and an additional seven years of commodities research experience. The Surveillance Manager has 30 years of market surveillance and compliance experience, which includes over 25 years at NYBOT and several years at the Commission and its predecessor, the Commodity Exchange Authority. The EFP/Operations Manager has worked for the Exchange for 17 years in research and economic functions, and has more than six years of experience with EFP reviews. The remaining MSD staff has combined market surveillance and compliance experience totaling more than 40 years.

[5] Active markets on the former Division A, the CSCE, include coffee C, sugar #11, and cocoa. Less active markets include sugar #14 and ethanol. On the former Division B, the NYCE and its subsidiaries, active markets include cotton #2 and frozen concentrated orange juice ("FCOJ"), while less active markets include cash settled financial

large traders and contract expirations, in their respective markets on a daily basis. In addition, both manage the processing of position limit exemption requests for their assigned markets and oversee any market surveillance related investigations. With respect to the Division A markets, the Managing Director is assisted by the Senior Database Clerk, the EFP/Operations Manager, and the Operations/EFP Assistant. The Senior Database Clerk assists the Managing Director with routine surveillance activities, while the EFP/Operations Manager and Operations/EFP Assistant conduct monthly EFP reviews, and have other responsibilities related to the Exchange's Statistics Department. With respect to the Division B markets, the Database Analyst assists the Surveillance Manager in performing routine surveillance and the Senior Database Clerk/Surveillance Assistant conducts monthly EFP reviews and other surveillance tasks, as assigned.

MSD's routine surveillance activities include daily monitoring of prices, volume, and open interest to detect potential price distortions and market congestion. Staff also monitors daily price movements and spread relationships, market news, deliveries, physical supplies, and other factors that could affect NYBOT's markets. Clearing member and large trader positions also are monitored daily to ensure compliance with speculative and hedge exemption position limits. Further, MSD regularly contacts trade sources and large market participants to keep informed of cash market developments and delivery intentions. In addition, weekly summaries of long and short position holders in the nearby contract are prepared for review by the Vice President of Market Regulation.

The MSD's staffing levels are adequate given the number of active markets at NYBOT.

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instruments and index contracts, as well as several cross currencies that are traded after hours on NYBOT's Dublin FINEX floor.

B. Surveillance of Expiring Contracts

To ensure orderly liquidations, MSD intensifies surveillance during contract expirations. MSD typically begins its enhanced surveillance approximately three weeks prior to the first notice day for coffee and cocoa and three weeks prior to the spot month limit taking effect for sugar #11.[6] Surveillance of the cotton and FCOJ contracts is intensified approximately 40 business days before the last trading day in those commodities.

With the exception of the Exchange's financial contracts, surveillance of expiring contracts is conducted in the same manner for all contracts.[7] MSD focuses on position concentrations, large trader positions, deliverable supplies, and the relationship between open interest and deliverable supplies. MSD also gathers information about cash market prices and supplies, and any other factors that may affect an orderly liquidation. It also contacts holders of large positions to ascertain their intentions with respect to making or taking delivery as contract expiration approaches. Prior to first notice day, and spot month position limits taking effect, MSD sends reminder letters to traders whose current positions are approaching speculative position limits and who might be eligible for a hedge exemption. Exchange rules require that such exemption requests be submitted at least five business days before the reduced position limit takes effect.[8]

The Exchange's Control Committee is responsible for directing the Exchange's market surveillance activities and works closely with MSD to ensure orderly contract expirations.

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[6] First notice day typically occurs four weeks before the last trading day in coffee and cocoa, and the spot month limit for sugar #11 typically takes effect 12 business days before expiration.

[7] Since availability of deliverable supply is not relevant for cash settled index contracts and generally is not of significant concern for financial instruments that are in plentiful supply, MSD staff focus their attention on clearing member and large trader position information in these markets.

[8] *See* pp. 13-17 below for further discussion of hedge exemptions.

Currently, there are five standing Control Committee subcommittees, one for coffee, cocoa, sugar #11, cotton, and FCOJ.[9] The subcommittees have the authority to obtain position information, compel testimony by members and the production of books and records, and to investigate and take action in any situation that may jeopardize the Exchange.[10]

MSD is responsible for keeping the Control Committee subcommittees informed regarding market conditions prior to and during delivery periods. The coffee and cocoa subcommittees meet at least one week prior to first notice day. The sugar #11 subcommittee meets at least one week before the spot month limit takes effect. Cotton and FCOJ subcommittee meetings are scheduled on an as needed basis. Prior to a Control Committee meeting, MSD provides the respective subcommittee with, among other things, a report that includes: (1) the largest position holders (with identities coded) that shows whether the trader is a commercial or non-commercial, (2) clearing member positions and charts, (3) data on open interest and spread relationships, and (4) information on deliverable supplies. Also included are minutes from the last subcommittee meeting. During the target period, there were a total of 18 subcommittee meetings. The subcommittee meetings for coffee (five), cocoa (five), and sugar #11 (four) were the routine meetings convened prior to expiration.[11] The Control Committee's cotton and FCOJ subcommittees each held two meetings.

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[9] If any issues arose with respect to the expiration of a financial instrument, index contract, or cross currency contract, the Chairman of the Control Committee would convene a subcommittee.

[10] NYBOT Rule 3.12. Control Committee members may not be Board members. Each subcommittee must include at least three Control Committee members. A committee member may not serve on a subcommittee if that person is identified with the contract for which the subcommittee has jurisdiction.

[11] Although the coffee, cocoa, and sugar #11 subcommittees meet at least once in connection with each contract's expiration, they may meet more frequently if market conditions so require.

MSD maintains expiration files for the coffee, cocoa, sugar #11, cotton, FCOJ, and index and financial contracts.[12] DMO reviewed expiration files for two agricultural contracts (May 2004 sugar #11 and December 2004 cotton) and two financial index contracts (September 2004 U.S. Dollar and June 2004 Russell 1000). DMO found that the files were well documented and reflective of the surveillance activities conducted. The files examined typically included coded weekly large trader reports, open interest charts, spot month exemptions, notes and memoranda concerning discussions with large market participants, trader intentions, and deliverable supply data. The sugar #11 and cotton files also included minutes of the respective Control Committee subcommittee meetings.[13]

In addition, the December 2004 cotton file thoroughly documented staff's and the subcommittee's heightened surveillance of that expiration. Surveillance was heightened when a major long position holder in the market indicated to MSD staff that the trader was going to take delivery on a large position during a tight deliverable supply situation. The tight supply situation developed because growers were placing their cotton into the U.S. Department of Agriculture's "loan" program due to low cotton prices.[14] A cotton subcommittee was convened on November 16, 2004 to discuss the situation. The subcommittee Chairman instructed MSD staff to closely monitor deliverable supply, market composition and price, and to contact the large trader daily to get the terms of any liquidating orders he was placing. The subcommittee Chairman and MSD

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[12] The MSD also monitors low-volume contracts daily, such as sugar #14, but generally does not maintain expiration files for those contracts. However, if there was an unusual or problematic expiration, an expiration file would be maintained.

[13] The minutes for Control Committee meetings held during the target period can be found in Appendix 3.

[14] The Non-recourse Marketing Assistance Loan and Loan Deficiency Payment Program are administered by the U.S. Department of Agriculture. The program provides producers with the financing to store harvested crop production rather than immediately selling the crop. Producers can have funds to pay bills without having to sell the harvested crop if prices are low. When the adjusted world price ("AWP") for upland cotton falls below the loan rate, producers can repay loans at the AWP level. Alternatively, an eligible producer may choose to receive a loan deficiency payment ("LDP") in return for forgoing the loan. When market conditions allow an LDP, the payment is based on the difference between the loan rate and the AWP.

staff maintained close observation of the market as a gradual decline in open interest reduced any potential delivery problems. In the end, the December 2004 cotton contract expired in an orderly fashion without disruption. There were no other problematic expirations during the target period.

C. Large Trader Reporting System

NYBOT clearing members transmit daily computerized large trader reports, including all reportable futures and options positions to the Exchange. Exchange rules specify that once a trader reaches the reportable level in one contract, then all of that trader's positions in that particular commodity must be provided to the Exchange.[15] Non-member futures commission merchants ("FCMs") and foreign brokers are required to provide daily large trader reports, including reportable futures and options positions to the Exchange by e-mail or fax.

Reportable positions are processed into the Exchange's large trader reporting systems daily. In order to calculate futures-equivalent positions, an account's daily futures positions are combined with its options on a delta-adjusted basis.[16] In addition, related and/or commonly-controlled accounts are aggregated. Once position data have been entered into the Exchange's large trader reporting systems, reports are generated to detect speculative position limit violations and for general market surveillance purposes. MSD staff view these reports daily on screens and in hard copy form.

MSD uses two different computerized larger trader reporting systems. The Speculative Limits Information Management ("SLIMS") system is used for NYBOT's former Division A

[15] NYBOT Rule 6.15.

[16] "Delta" is the measure of the sensitivity of an option's value to a change in the price of the underlying futures contract, and is also referred to as an options futures-equivalent position. Deltas are positive for calls, and negative for puts.

markets, and a database system coupled with FoxPro query software ("FoxPro System") is used for the former Division B markets.[17] Both SLIMS and the FoxPro System, though independent systems, are capable of performing similar monitoring of trading data for their respective contract markets and produce similar reports. However, the FoxPro System has query capabilities that allow staff to sort data by a number of variables for both futures and options. For example, while both systems can generate a report identifying large trader positions for a selected market by contract month, the FoxPro System can sort data by size, type of trader (commercial/non-commercial), etc. The analogous SLIMS report will simply list the positions by account holder, and any further sorting must be done manually.

In addition, both SLIMS and the FoxPro System produce a "Speculative Limits Violations Selection Report." This report is used to view every reportable position or to review position holders maintaining a selected percentage of the speculative position limit. The SLIMS version can be set to display reportable positions at any selected percentage of the speculative position limit, while the FoxPro System's version only displays those positions at 75 percent or more of the speculative limit. SLIMS and the FoxPro System also produce similar reports that show all omnibus account positions for a particular date. Identified customers are listed with the omnibus account. Staff reviews these reports to determine if there are omnibus accounts that may have reportable positions which are not providing the Exchange with a large trader report. When this occurs, MSD contacts the omnibus accounts directly to determine if they have reportable positions. If so, the omnibus accounts are directed to report such positions to the Exchange daily by fax or e-mail.

[17] The Speculative Limits Options Positions ("SLOPS") system is used in conjunction with SLIMS for the Division A markets. SLIMS/SLOPS and the FoxPro System are essentially the systems that were in place at CSCE and NYCE, respectively, prior to the merger of the two exchanges.

Other reports and screens generated by the Exchange's large trader reporting systems show reportable positions by account or in the aggregate; compare cleared long and short positions to reported positions for each clearing member (which allows staff to ensure that there are no reporting discrepancies); list all unidentified reportable accounts by clearing member;[18] display a specified account's identifying information, including the name of the aggregate to which the account may belong; list all reportable accounts held by traders who use more than one clearing member; list aggregated accounts and accounts included within each aggregation, as well as the clearing member where each account is carried; and display position information for all reportable accounts or selected accounts, and for clearing members.

The Exchange is working to merge its large trader reporting systems and have an integrated system incorporating the positive features of each system. The Exchange plans to have the new system operating by December 2005.

D. Enforcement of Speculative Position Limits, Hedge Exemptions, and Position Accountability

1. Exemptions from Speculative Position Limits

The Exchange's speculative limit rules set forth the maximum number of net futures-equivalent contracts (futures and options) which any one person may own or control on the same side of the market without an exemption approved by the Exchange. Pursuant to NYBOT Rules 6.26, 6.27, and 6.28, the Exchange may grant speculative position limit exemptions for bona fide hedging, arbitrage and straddle positions, and independently controlled positions.[19] Exemptions

[18] The MSD requests a CFTC Form 102 to identify reportable accounts. In addition to identifying a particular account, the form provides account control and contact information. If an unidentified account has a large position, account identification is immediately requested by telephone, to be followed by a Form 102. If a large position is not involved, the account is given five business days to file a Form 102. Upon receipt of the Form 102, MSD staff determines if an aggregation code must be assigned to the account, if one doesn't already exist.

[19] NYBOT Rule 6.28 defines an "Independent Account Controller" as a person who (1) is registered with the Commission as either an FCM, introducing broker, commodity trading advisor, or as an associated person of any

may be granted for non-spot single month and net all months combined limits (sugar #14 and FCOJ), notice period limits (coffee, cocoa, and FCOJ), and spot month limits (sugar #11 and ethanol).[20] With respect to NYBOT's former Division B markets, DMO's Market Surveillance section is notified when spot month exemptions are granted and is periodically provided with a listing of exemptions in any single month and all months combined. Similar information is provided for NYBOT's former Division A markets upon request by DMO.

To apply for a single month and/or a net all months combined position limit exemption, an exemption request form must be filed with the Exchange. The form must be signed by a NYBOT member or an officer or partner of a NYBOT member firm. When reviewing the request, MSD considers the size of the requested position with respect to open interest, the principal business and occupation of the requestor, the requestor's historical level of futures and options positions, the requestor's inventories and uncovered purchases and sales in the physical market, and any other information staff may consider relevant to the request. Within five days of the submission of a completed request, the applicant is informed in writing whether the exemption has been granted, partially granted, or denied.[21] Approved exemption quantities are

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such registrant; (2) is authorized by an eligible entity (such as a commodity pool operator or a commodity trading advisor which authorizes a person to independently control trading decisions for its positions, or any other person or entity deemed exempt by Commission regulations or guidelines, including Regulation 150.3) to control independently trading by, and on behalf of, but without the day-to-day direction of the eligible entity; (3) trades independently of the eligible entity and of any other Independent Account Controller trading for the eligible entity; (4) is supervised by the eligible entity only to the degree necessary to fulfill its fiduciary responsibilities and duty to supervise diligently the trading done on its behalf; and (5) has no knowledge of trading decisions by any other Independent Account Controller.

[20] During the target period, NYBOT's cotton #2 contract was subject only to the speculative position limits set forth in Part 150 of the Commission's regulations and all exemption requests were filed with the Commission. In June 2005, NYBOT adopted its own speculative position limits for the cotton #2 contract. Exemption requests for cotton #2 must now be filed with the Exchange, as well as with the Commission.

In addition to speculative limits, as discussed below on p. 18, position accountability levels apply to net overall positions in cocoa, coffee, sugar #11, and seven cross currency contracts.

[21] A copy of this letter must be signed by a NYBOT member or an officer or partner of a NYBOT member firm and returned to the Exchange.

entered into either SLIMS or the FoxPro System, depending on the contract, along with the date the exemption was granted.

All single month and net all months combined exemptions are reviewed annually to ensure that outstanding exemption levels continue to reflect the nature and scope of the exemption holder's business. The Exchange sends a letter to each exemption holder asking it to resubmit an exemption request if any material change has occurred in its business. The holder may maintain its current exemption by signing, dating, and returning the letter. MSD revokes the exemptions of holders who do not respond. The date that an exemption is updated is entered into SLIMS or FoxPro. The Exchange reviewed all single month and all months combined exemptions in the fourth quarter of 2004.

The exemption process for notice period and spot month exemptions is similar to that for single month and net overall month exemptions, except that exemption requests are due no later than five business days before the notice period or spot month position limit takes effect. Approximately five business days before such requests are due, MSD sends a reminder letter to traders whose current positions exceed position limits. Notice period and spot month exemptions expire on the last trading day for the contract for which the exemption was granted.

A trader whose position is approaching or exceeds any of the Exchange's current limits may also request an exemption or expansion of a current exemption level by verbally providing MSD with the information needed to process the request. If the exemption is granted, the applicant must file a completed exemption request form with MSD within 24 hours.

During the target period, all of the arbitrage and straddle exemptions granted were of the "cash-and-carry" variety. The Exchange granted a total of 34 cash-and-carry exemptions. A cash and carry exemption allows a trader to take delivery in the near month and redeliver the same product in a deferred month at a profit.[22] With respect to cash-and-carry exemption requests, the applicant must provide its cost of carry and the minimum spread at which the trader will enter into a straddle position which would result in an economic profit. The applicant also must provide the quantity of stocks in Exchange licensed warehouses that it already owns and the applicant's entire long position carried into the notice period must have been put on at a differential that covers the applicant's cost of carry. Further, the applicant must agree to liquidate any long positions in excess of the notice period position limit before the nearby month rises to a premium to the second futures month. Cash-and-carry exemptions are typically granted in stages and are expanded if requested and if appropriate to market conditions.

MSD's Managing Director and Surveillance Manager have the authority to grant exemptions. In the event that an exemption request is deemed large or unusual, the Vice President of Market Regulation and, if need be, the Control Committee are consulted before a final determination is made regarding approval. As stated earlier, when reviewing any request, MSD staff considers the size of the requested position with respect to open interest, the principal business and occupation of the requestor, the requestor's historical level of futures and options positions, the requestor's inventories and uncovered purchases or sales in the physical market, and any other information staff considers relevant to the request. Particular emphasis is placed on current cash and futures commitments, delivery intentions and deliverable supplies. The applicant must justify the entire position requested, not only the amount in excess of speculative position limit.

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[22] In carrying-charge markets, current deliverable stocks are usually adequate and prices are higher for deferred expiration months. Traders may request cash and carry exemptions when the spread between the expiring contract and next delivery month exceeds carrying charges. Thus, a trader who has purchased the near month and sold the deferred month may profit by taking delivery and redelivering the next month.

DMO randomly reviewed 32 out of 93 position limit exemption requests filed during the target period and 22 letters confirming the renewal of overall and/or single month exemptions.[23] In some cases, the Exchange granted only part of a requested hedge exemption or denied an exemption based on information provided by the applicant or the lack of such information. The exemption files examined by DMO were well documented. The files indicated that the Exchange thoroughly reviewed exemption requests, and appeared to grant exemptions at appropriate levels.

2. Monitoring Position Limits and Hedge Exemptions

MSD staff reviews large trader positions daily for compliance with speculative position limits and/or position limits granted by exemptions. The Exchange's large trader reports identify Division A traders that are at or above 80 percent of their position limits and Division B traders that are at or above 75 percent of their position limits. MSD either telephones or faxes a letter to such traders reminding them that they are approaching their position limit and they may need to apply for an exemption or an expansion of a current exemption, if appropriate. When a member exceeds a position limit, staff contacts the member by telephone. If the account belongs to a non-member customer and the position is carried by one clearing member, the Exchange contacts the carrying clearing member, who in turn contacts its customer. When a position limit has been exceeded due to unforeseen bona fide hedging needs, MSD allows the trader to file an exemption request that must be received by MSD within five business days (10 business days for FCOJ). If the exemption request is approved by MSD, there is no violation.

[23] The selected files reviewed included exemption requests for FCOJ, coffee, sugar #11, and cocoa futures, and renewal letters for FCOJ and sugar #14 exemptions. No exemption requests were received during the target period for any financial or index contracts.

DMO found that the Exchange addresses potential speculative limit position violations in a timely manner and that MSD's files adequately document staff's efforts in this regard. During the target period, the MSD opened and closed eight investigations involving potential position limit violations.[24] Violations were found in seven of the eight investigations, which resulted in five warning letters and three informational letters being issued to first time offenders.[25] Although warning letters are not typically issued to non-members, during the target period one of the warning letters was sent to a non-member for violating FCOJ position limits. The same non-member again violated FCOJ's position limits on various dates beginning in December 2004, continuing through February 2005 (after the target period). This resulted in the Exchange sending another warning letter on March 19, 2005. Because the Exchange lacks disciplinary authority over non-members, the Exchange referred the apparent speculative limit violations to the Commission for further investigation.

3. Position Accountability

MSD staff also monitors for violations of the Exchange's position accountability rules using the same large trader reports that it uses to monitor speculative limits. Position accountability levels apply to net overall positions in cocoa, coffee, sugar #11, and to seven cross currency contracts.[26] When a position accountability level is initially reached, MSD staff contacts the account holder. If the account holder cannot be reached, clearing members or FCMs

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[24] Five of these matters were referred to the Exchange by DMO's Market Surveillance section. According to the Exchange, MSD staff had been aware of the violations and had been in contact with DMO's surveillance staff regarding the violations prior to receiving formal Commission referral letters.

[25] An "informational letter" reminds a non-member of rule provisions that apply to a non-member's conduct and serves to put non-members on notice that the Exchange views certain actions as potential rule violations. Warning letters are typically sent to Exchange members and become part of a member's disciplinary history.

[26] The seven currency contracts are: Australian Dollar/New Zealand Dollar; Euro/Czech Koruna; Euro/Hungarian Forint; U.S. Dollar/Hungarian Forint; U.S. Dollar/Czech Koruna; U.S. Dollar/African Rand; and New Zealand Dollar/U.S Dollar.

carrying the position are contacted. Information is collected and documented regarding the nature of the position (*e.g.*, hedging, speculative, arbitrage), trading strategy, how large the account holder anticipates the position may become and any other information staff considers relevant. If the account that has breached the position accountability level is familiar to staff due to past exemption requests, it may not be necessary to contact the account at the time the position level is breached. NYBOT's position accountability rules grant the Exchange the authority to instruct an account not to increase its position any further.[27] This authority can be invoked due to liquidity concerns or for other reasons that the Exchange feels might negatively impact the market.

During the target period, NYBOT opened one position accountability inquiry. DMO found that this inquiry, which involved the sugar #11 contract, was thorough and completed in a timely manner. After analyzing the size and nature of the trader's positions, and taking into account the trader's trading strategy, MSD increased the trader's position accountability level.

E. Exchange of Futures for Physicals and Exchange of Futures for Swap Transactions

NYBOT Rule 4.12 permits EFPs by means of related and simultaneous cash and futures transactions in which the buyer and seller of the futures are, respectively, the seller and buyer of an approximately equivalent quantity of the physical commodity. EFP transactions may be effected in all futures contracts offered for trading on the Exchange. Rule 4.12 also permits EFSs by means of related futures and swap transactions in which the buyer and seller of the futures are, respectively, the seller and buyer of a swap involving an approximately equivalent quantity of the commodity underlying the futures contract (or a derivative, by-product or related product of such commodity). For both EFPs and EFSs, the Exchange also requires that the buyer

[27] NYBOT Rules 6.17, 6.18, 6.22, 6.24.

and seller be separate parties, or, if they are related or affiliated entities, that they be under separate control.[28]

1. Routine EFP Reviews

Each month, MSD selects six EFP/EFS transactions (four agricultural and two financial transactions) for review to ensure the bona fides of the transactions. During the target period, the exchange completed 12 EFP/EFS reviews that examined 72 EFP and two EFS transactions.[29] The Exchange's selection criteria include, among other things, EFPs/EFSs that involve an unusually large size, have the same customer account on both the buy and sell side of the transaction, or have the appearance of a new clearing member or trader who does not typically engage in EFPs/EFSs. The Managing Director also may recommend that particular EFPs/EFSs be reviewed. If a sufficient number of transactions meeting the above criteria are not found, then transactions are randomly selected. Once a transaction is selected for review, the Exchange requests that the clearing members produce trade confirmation statements indicating the account into which the EFP/EFS cleared. For EFPs, the Exchange also requests documentation supporting the cash side of the transaction, such as a commercial contract, warehouse receipt, or price-fixation letter. For EFSs, the Exchange requests copies of a master swap agreement.

The elements of each EFP/EFS reviewed by MSD include ascertaining that the buyer and seller of the futures are, respectively, the seller and buyer of the physical commodity/swap as evidenced by the names on the trade confirmation statements and cash or swap documents, and that there was an actual transference of the physical commodity/swap; that the buyer and seller

[28] *See* NYBOT Rule 4.12 and Questions and Answers ("Q&As") explaining the Exchange's February 2002 amendments to its EFP and EFS rules and the appropriate procedures. The Q&As can be found in Appendix 4.

[29] During the target period, the number of contracts executed via an EFP far outweighed the number of contracts executed via an EFS. Specifically, 2,343,285 contracts were executed through EFP transactions and 121,544 contracts were executed through EFS transactions. This represented approximately 10 percent of the Exchange's 2004 total volume.

are different entities, or, if they are related or affiliated, that they are under separate control; and that the quantity covered by the cash or swap transaction is approximately equivalent to the quantity of the futures transaction. Upon completion of an EFP/EFS review, a summary is prepared that includes a listing of the clearing members examined, an EFP/EFS trade report that lists all of the EFPs/EFSs executed for the selected clearing members for a selected date, the supporting documentation submitted by members and/or customers, and a description of each EFP/EFS transaction.

DMO examined all of the Exchange's EFP/EFS reviews for adequacy. The reviews were generally thorough and well-documented, and included appropriate analysis to determine whether the transactions satisfied the Exchange's EFP or EFS requirements. The documentation for each transaction examined indicated that: (1) the accounts involved had different beneficial owners or were under separate control, (2) a change in ownership of a physical commodity for an EFP or a swap for an EFS occurred, and (3) that the quantity covered by the cash or swap transaction was approximately equivalent to the quantity of the futures transaction. One of the EFP transactions reviewed was expanded into a separate investigation that resulted in warning letters being issued to two clearing members for failing to submit documents demonstrating that the EFP was a bona fide transaction.

2. EFP Investigations

In addition to the one investigation that resulted from a routine EFP review, the Exchange opened nine EFP investigations that resulted from referrals from DMO's Market Surveillance staff. DMO's referrals identified several EFPs which it believed involved either the same entity or entities under common control on both sides of the transaction.[30] Currently, the Exchange's EFP/EFS Report lists for each trading day the EFPs/EFSs cleared by each clearing member. The data provided includes, among other things, the commodity, contract, opposite clearing member, and the customer account number. To ascertain whether the parties to an EFP are related entities is a cumbersome process that requires MSD staff to examine several EFP/EFS reports and then access the Exchange's large trader reporting systems to identify the names associated with account numbers. The Exchange has informed DMO that its new integrated large trader reporting system will produce an EFP/EFS report that will contain identities of reportable accounts. This will allow MSD to more readily identify EFPs/EFSs that may involve related entities and to review those transactions for which there is a question with respect to separate control of the involved accounts.

DMO reviewed all of the Exchange's EFP/EFS investigations and found that several were not conducted in a thorough manner. In five instances, MSD sent either the clearing firm or the customer a standard document request similar to that which it uses for its monthly EFP reviews. This request asks for specific documentation underlying the cash exchange which assists MSD in determining whether an EFP is a bona fide transaction that satisfies all of the Exchange's EFP requirements.[31] However, DMO identified four other EFP investigations where, rather than issuing a standard document request, MSD only inquired as to whether the buyer and seller were under separate control. MSD did not request the documentation necessary to determine the existence of a related cash transaction or to verify the transference of the actual physical commodity. Although separate control was the central issue in DMO's referrals, the

[30] The MSD's summary close-out memorandum for four of DMO's referrals notes that documents had already been requested for one of the referred matters prior to DMO's referral. A copy of the April 1, 2005 memorandum can be found in Appendix 5.

[31] A copy of a sample standard EFP document request can be found in Appendix 6.

Exchange should have requested underlying cash-side documentation to evaluate fully the bona fides of the EFPs.

The Exchange's EFP investigations also revealed that the requirement of separate control for affiliated entities may not be fully understood by members and their customers. In this regard, three of the five warning letters and both informational letters issued for EFP violations related to non-compliance with the Exchange's requirement that affiliated parties to an EFP be under separate control. In each case, it appeared that the subjects of the investigation were unaware of, or did not understand, the Exchange's rule in this regard. Therefore, the Exchange should issue a notice reminding members of the separate control requirement of NYBOT's EFP rule and how it can be satisfied, and request that members share this information with their customers who engage in EFPs.

IV. CONCLUSIONS AND RECOMMENDATIONS

DMO found that the Exchange maintains an adequate market surveillance program that includes daily monitoring of prices, volume, open interest, spread relationships, large trader positions and market news. In addition, MSD staff keeps informed of cash market developments and delivery intentions. Surveillance of expiring contracts typically includes focusing on position concentrations, deliverable supplies, and the relationship between open interest and deliverable supplies. Staff also works closely with the Control Committee and its subcommittees, which are responsible for directing the Exchange's market surveillance activities. Staff keeps the committees informed of market conditions prior to and during delivery periods. During the target period, there was one non-routine expiration that involved the December 2004 Cotton contract. MSD heightened its surveillance of that contract and was in frequent contact with the subcommittee Chairman. The contract expired in an orderly manner without disruption.

The Exchange maintains two large trader reporting systems that produce similar large trader reports and provide staff with the capability of performing similar monitoring of trade data for their respective markets. These two systems will be integrated into a single system in December 2005. DMO also found that the Exchange has adequate procedures to review hedge exemption applications and to monitor for speculative limit violations and accounts that exceed position accountability thresholds.

In addition, each month, the Exchange opens a routine EFP/EFS review to examine six EFP/EFS transactions for compliance with Exchange rules. DMO found that the 12 reviews completed during the target period were through and well documented, and included appropriate analysis to determine whether the EFPs/EFSs were bona fide transactions that satisfied the Exchange's requirements. The Exchange also opened 10 EFP investigations during the target period, one which resulted from a routine EFP review and nine which resulted from referrals from the DMO's Market Surveillance staff. The referrals questioned whether particular EFPs involved the same entity or entities under common control, a violation of NYBOT Rule 4.12. The Exchange's new integrated large trader reporting system will provide MSD with the ability to more readily identify EFPs involving related entities.

DMO reviewed each of the EFP investigations and found that several were not conducted in a thorough manner. Specifically, DMO identified four investigations where rather than seeking documentation to determine the existence of an underlying cash transaction and to verify the transference of the physical commodity, MSD only inquired as to whether the affiliated buyer and seller were under separate control. Although separate control was a key issue in the investigations, DMO believes that any EFP subject to review should be fully examined to properly evaluate the bona fides of the transaction. DMO also found that the requirement that affiliated accounts engaging in EFPs be under separate control may not be fully understood by members and their customers. In this connection, DMO notes that three of the five warning letters and both informational letters issued for EFP violations related to non-compliance with this requirement. In each case, it appeared that the persons involved were unaware of, or did not understand, the Exchange's rule in this regard.

Based on the foregoing, DMO recommends that the Exchange:

- **Request underlying cash-side documentation for all EFPs under review, regardless of whether they emanate from a routine review or a Commission referral, to evaluate fully compliance with all provisions of the Exchange's EFP rule.**
- **Issue a notice reminding members of the separate control requirement of NYBOT's EFP rule and how it can be satisfied, and request that members share this information with their customers who engage in EFPs.**