

**TRADE PRACTICE
RULE ENFORCEMENT REVIEW
OF THE
CBOE FUTURES EXCHANGE, LLC**



Division of Market Oversight

June 24, 2016

I. Rule Enforcement Review Scope

The Division of Market Oversight (“Division”) has completed a rule enforcement review of the trade practice surveillance program of the CBOE Futures Exchange, LLC (“CFE” or the “Exchange”).¹ The review focused on compliance with two core principles under Section 5(d) of the Commodity Exchange Act (“Act” or “CEA”),² as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”)³ and Part 38 of the Commission’s regulations. The Division’s review focused on Core Principles 2 (*Compliance With Rules*)⁴ and 12 (*Protection of Markets and Market Participants*),⁵ and Commission regulations 38.150;

¹ Rule enforcement reviews prepared by the Division are intended to present an analysis of an exchange’s overall compliance capabilities during the period under review. Such reviews deal only with programs directly addressed in the review and do not assess all programs or core principles. The Division’s analyses, conclusions, and recommendations are based, in large part, upon the Division’s evaluation of a sample of investigations 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 findings and recommendations in this rule enforcement review are limited to the Exchange and its respective products. This rule enforcement review, and the findings and recommendations herein, represent the view of the Division only, and do not necessarily represent the position or view of the Commission or of any other office or division of the Commission.

² 7 U.S.C. 1 et seq.

³ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

⁴ Core Principle 2 – Compliance with Rules:

- A. IN GENERAL – The board of trade shall establish, monitor, and enforce compliance with the rules of the contract market, including-
 - i. access requirements;
 - ii. the terms and conditions of any contracts to be traded on the contract market; and
 - iii. rules prohibiting abusive trade practices on the contract market.
- B. CAPACITY OF CONTRACT MARKET – The board of trade shall have the capacity to detect, investigate, and apply appropriate sanctions to any person that violates any rule of the contract market.
- C. REQUIREMENT OF RULES – The rules of the contract market shall provide the board of trade with the ability and authority to obtain any necessary information to perform any function described in this subsection, including the capacity to carry out such international information-sharing agreements as the Commission may require.

⁵ Core Principle 12 – Trade Information:

151(a); 151(c); 152, 153, 154; 155, 156, 158; and 650–651.⁶ The Division’s review of the Exchange’s trade practice surveillance program covered the period from March 1, 2014 to February 28, 2015 (“target period”).⁷

In conducting this review, Division staff held on-site interviews with officials and staff from the Exchange on July 22, 2015 and with its regulatory services provider, the National Futures Association (“NFA”), on July 21, 2015. During these interviews, the Exchange and NFA provided a demonstration of the electronic systems used to perform trade practice surveillance. A follow-up on-site interview was held on March 8, 2016 to discuss organizational and staffing changes that occurred after the target period. The Division also reviewed numerous documents produced by the Exchange and NFA, including the following:

- Policies and procedures used to conduct trade practice surveillance, including the CFE Investigation and Procedures Manual (“Compliance Manual”) and NFA’s Market Regulation Procedures;
- Organizational charts and summaries of personnel and staffing;

The board of trade shall establish and enforce rules—

- A. to protect markets and market participants from abusive practices committed by any party, including abusive practices committed by a party acting as an agent for a participant; and
- B. to promote fair and equitable trading on the contract market.

⁶ See Appendix B for a table of Core Principles and Regulations Reviewed. Commission regulations 38.151(b), 38.157, and 38.159 were not reviewed directly because this review focused only on regulations related to trade practice surveillance. In addition, the Division’s review of Commission regulation 38.151(c) was limited in scope to suspensions and revocations of access imposed in connection with trade practice matters that were closed during the target period. Because the substantive requirements of Core Principle 12 that relate to trade practice surveillance are similar to those of Core Principle 2, the Division has evaluated compliance with Core Principle 2 and the selected regulations listed herein rather than conduct a separate review of Core Principle 12 and its associated regulations, Commission regulations 38.650-651.

⁷ Based on the organizational and staffing changes that CFE experienced during the target period and after, the Division reviewed, as part of this rule enforcement review, the impact of these changes on the trade practice surveillance program, including the adequacy and timeliness of investigations that were conducted after the target period.

- Investigation documents and associated work product for all trade practice investigations that were closed during the target period, as well as a sample of trade practice investigations that were closed after the target period;
- Minutes of meetings of the CFE Board of Directors and its Regulatory Oversight Committee (“ROC”) held during the target period;
- Reports from the Exchange’s tracking system for the disposition of trade practice matters; and
- The Regulatory Services Agreement (“RSA”) between the Exchange and NFA, which describes the scope of the self-regulatory services to be performed by NFA on behalf of the Exchange.

The Division analyzed the Exchange’s trade practice surveillance program to determine whether the program was in compliance with the core principles and Commission regulations stated above during the target period, and whether there were any deficiencies with, or recommendations for, the program. For purposes of this report, a *deficiency* is an area where the Division believes the Exchange is not in compliance with a Commission regulation and must take corrective action, and a *recommendation* concerns an area where the Division believes the Exchange should improve its compliance program.

As set forth below, the Division found that the Exchange generally demonstrated compliance with Core Principles 2 and 12, and Commission regulations 38.150; 151(a); 151(c); 152; 153; and 650–651. The Division found one deficiency and made two recommendations under Commission regulation 38.155; one recommendation under Commission regulation 38.156; one deficiency and two recommendations under Commission regulation 38.158; and one recommendation and one deficiency under Commission regulation 38.154.

The Division provided the Exchange and NFA an opportunity to review and comment on a draft of this report on May 17, 2016. On May 23, 2016 and May 25, 2016, Division staff conducted exit conferences with officials from the Exchange and NFA, respectively, to discuss the report's findings and recommendations.

II. Summary of Findings, Recommendations, and Deficiencies Requiring Corrective Action

A. Findings without Recommendations or Deficiencies

1. Rulebook and jurisdiction (Core Principle 2, Commission regulations 38.150, 38.151(a), 38.152)
 - The Division found that the CFE Rulebook (“Rulebook”) extends jurisdiction to any trading privilege holder or authorized trader, as well as any person initiating or executing a transaction on or subject to the rules of the Exchange directly or through an intermediary, and any person for whose benefit such a transaction that has been initiated or executed. The Rulebook also prohibits the trade practice violations enumerated in Commission regulation 38.152.
2. Capacity to detect rule violations (Core Principle 2, Commission regulation 38.153)
 - NFA’s trade practice surveillance conducted on behalf of the Exchange seeks to identify the following types of potential violative trading activity: trading ahead of customer orders, trading against customer orders, accommodation/non-competitive trading, improper cross trading, front running, wash trading, pre-arranged trading, money passing, stop order fishing, marking the close and spoofing. In addition to the surveillance conducted by NFA, in April 2015, the Exchange developed its own proprietary VIX Manipulation Tool. The Exchange has also developed a Cross-market Spoofing tool that is currently being enhanced and is planning to develop a Cross-market Frontrunning tool. The Division found that the surveillance tools used by both NFA and CFE are adequate for detecting rule violations.
3. Investigations and investigation reports (Core Principle 2, Commission regulation 38.158)
 - NFA Market Regulation conducts trade practice investigations on behalf of the Exchange. If Market Regulation staff’s review indicates that a potential rule violation may have occurred, an Investigative Summary is prepared recommending that the Exchange review trading activity in

conjunction with specified rule(s) for potential disciplinary action. If the findings do not indicate a potential rule violation, a closure memo is prepared for the Exchange's review and the matter is closed administratively.

- Once an Investigative Summary is received by the Exchange, CFE staff review the referral to determine whether NFA's interpretation of the rules cited is appropriate or additional information is needed. Upon conclusion of the review, CFE staff will summarize the information obtained from the NFA referral, along with any additional information and analysis collected by the Exchange, into an Investigation Report with a recommendation as to whether disciplinary action should be pursued.
- Subject to the deficiency identified below with respect to Commission regulation 38.158(b) (timeliness of investigations) and the recommendation below regarding the Exchange's decision not to pursue disciplinary action, the Division found that the Exchange adequately conducted investigations during the target period. The Division found the quality of the investigative work in the cases reviewed to be thorough and complete.

B. Findings with Recommendations

1. Staffing (Core Principle 2, Commission regulation 38.155(a))

- The Exchange's Chief Regulatory Officer ("CRO") and the Deputy CRO both hold their respective titles at CBOE and CFE. As such, the Division is concerned that a number of factors could potentially affect the workload of the CRO and Deputy CRO, such as an increase in volume or the number of products traded at either CBOE or CFE.
 - **Recommendation: The Exchange should evaluate the workload of the CRO and the Deputy CRO on an ongoing basis to ensure that they are able to allocate sufficient time and resources to the CFE regulatory program.**
- The Division found that the Department of CFE Regulation ("CFER") experienced considerable turnover during the target period and the following year, including the departure of a total of seven investigators. Among the steps that were taken to address staffing turnover, the then-CRO raised her concern to the Human Resources Department and was told that a compensation study conducted in 2012 indicated that CFE's salaries were competitive. The CRO did not participate in the formulation of the study and did not receive a copy of the study.
 - **Recommendation: CFE should continue to examine the underlying reasons for the large number of staff departures**

over the target period and thereafter. The Exchange should consider conducting a further compensation study to determine whether CFE is offering competitive compensation and benefits to attract and retain qualified investigators as compared to its peers in the derivatives industry. CFE should ensure that the CRO and ROC are fully engaged in efforts to attract and retain qualified staff.

2. Automated trade surveillance system (Core Principle 2, Commission regulation 38.156)

- The Division found that NFA’s automated trade practice surveillance tools comply with Commission regulation 38.156. NFA uses exceptions, alerts, ad-hoc queries, and profiles to conduct trade practice surveillance on behalf of the Exchange. NFA reviews the exception parameters on a quarterly basis. The broad parameters are set forth in the RSA, signed by the Exchange.
 - **Recommendation: In conducting its review of the parameters of its automated surveillance system, NFA should consider whether exception parameters should be customized for CFE’s markets.**

3. Investigations and investigation reports (Core Principle 2, Commission regulation 38.158(a))

- Although CFE maintains a Compliance Manual, the Division found that the investigative procedures for conducting trade practice investigations were not well-documented.
 - **Recommendation: The Exchange should update its Compliance Manual to ensure that, at a minimum, the following investigative procedures are well-documented: (1) investigative procedures CFE follows in performing any surveillance activities not conducted by NFA; (2) procedures for reviewing referrals from NFA; (3) procedures for drafting the Investigation Report upon review of referrals from NFA; and (4) the supervisory review process of the Investigation Report.**
- The Division identified two instances—one that was closed during the target period and one that was closed after—in which it found the Exchange’s decision not to pursue disciplinary action was inappropriate. In both cases, the Exchange issued a warning letter for test orders and trades that were placed in the live trading environment, in violation of the Exchange’s rules against fictitious trading.

- **Recommendation: CFER should recommend and the Exchange should promptly take appropriate disciplinary action when it makes a finding that a violation of a substantive trading rule occurred.**

4. Regulatory decisions of the exchange (Core Principle 2, Commission regulation 38.154(c))

- CFE's RSA with NFA specifies that if CFE disagrees with NFA's recommendation relating to an investigation or if CFE's recommendation differs in any respect from NFA's recommendation then CFE shall notify NFA in writing of this decision along with an explanation as to why CFE disagrees with NFA's recommendation. However, the Division found that in three investigations, CFE did not document and share instances where it was not taking action with respect to a potential rule violation identified by NFA, and three investigations in which the Exchange did not document and share with NFA instances where it found additional potential rule violations.
 - **Recommendation: CFE should document and share with NFA all instances where the Exchange's actions differ from those recommended by NFA. Such documentation should adequately explain how the Exchange's recommendation differs in any respect from NFA's recommendation.**

C. Findings with a Deficiency Requiring Corrective Action

1. Staffing (Core Principle 2, Commission regulation 38.155(a))

- The Division found that the number of CFE and NFA staff dedicated to performing CFE regulatory functions at the end of the target period was sufficient. However, the considerable amount of staff turnover during the target period prevented the Exchange from maintaining, on a consistent basis, sufficient compliance staff during the target period to conduct and complete investigations in a timely manner, as required by Commission regulation 38.155(a).
 - **Deficiency: As required by Commission regulation 38.155(a), the Exchange must establish and maintain sufficient compliance department resources and staff to ensure it can conduct its self-regulatory functions, including completing investigations in a timely manner.**

2. Investigations and investigation reports (Core Principle 2, Commission regulation 38.158)

- During the target period, the Exchange closed four trade practice-related investigations. As explained in Appendix A, the average length of time these investigations were open was 649 days. One investigation remained open for 211 days, a second investigation remained open for 591 days, a third investigation remained open for 807 days and a fourth investigation remained open for 987 days. The Division did not identify any mitigating circumstances in the three investigations that were open for more than 365 days to justify the length of time that these cases were open. Commission regulation 38.158(b) requires that investigations be completed in one year or less, absent mitigating circumstances.
 - **Deficiency: As required by Commission regulation 38.158(b), the Exchange must complete investigations in one year or less, absent mitigating circumstances.**
3. Supervision of third-party regulatory service provider (Core Principle 2, Commission regulation 38.154(b))
- During the target period, the Exchange and NFA held periodic meetings and engaged in informal discussions about ongoing investigations and other matters of regulatory concern, as required by Commission regulation 38.154. However, it is not apparent from the Division’s review of the investigations that such discussions were always effective. For example, in three of the four investigations that were closed during the target period, the Division found that the Exchange either disagreed with the potential rule violations cited by NFA in its referral or considered additional potential violations that may or may not have ultimately been found to have occurred. The Exchange took 449 days after it received the referral from NFA to complete one of these investigations, 629 to complete the second investigation, and 798 days to complete the third investigation. It is the Division’s view that the Exchange could have reviewed NFA’s investigatory work in a quicker, more efficient manner—and, as a result, could have potentially completed investigations in a more timely manner—if the Exchange and NFA had engaged in clearer, more effective discussions regarding ongoing investigations and other matters of regulatory concerns.
 - **Deficiency: As required by Commission regulation 38.154(b), the Exchange must supervise the quality and effectiveness of the services provided by its third-party regulatory service provider, NFA. As part of the regular meetings with NFA, the Exchange must ensure that it adequately discusses “ongoing investigations, trading patterns, market participants, and any other matters of regulatory concern” (emphasis added). The Exchange should improve its documentation of the meetings and communications with NFA to ensure that all substantive**

discussions that affected either NFA or the Exchange's recommendation or disposition on a matter are captured.

Additional details regarding the facts and analysis relevant to the Division's review are contained in the Compliance Matrix in Appendix A.

Appendix A Compliance Matrix

CFTC Regulation	Findings Regarding Exchange’s Compliance	Deficiencies and Recommendations ⁸
Core Principle 2 – Compliance with Rules		
§ 38.150 Core Principle 2	See discussion below addressing Commission regulations 38.151 – 38.156 and 38.158.	No deficiencies or recommendations.
§ 38.151 ⁹ (a) Jurisdiction	In addition to asserting jurisdiction over any trading privilege holder (“TPH”) or authorized trader, the Exchange’s jurisdiction extends to any person initiating or executing a transaction on or subject to the rules of the Exchange directly or through an intermediary, and any person for whose benefit such a transaction has been initiated or executed. ¹⁰	No deficiencies or recommendations.
§ 38.152 Abusive trading practices prohibited	Chapter 6 of the Rulebook prohibits the trade practice violations enumerated in Commission regulation 38.152. ¹¹	No deficiencies or recommendations.
§ 38.155 Compliance staff and resources	The Exchange’s regulatory program is administered by the Department of CFE Regulation (“CFER” or “Department”), along with the Exchange’s regulatory service provider (“RSP”), the National Futures Association (“NFA”). NFA performs trade practice and market surveillance on behalf of the Exchange, while CFER conducts audit trail enforcement, performs market surveillance activities related to the settlement of Volatility Index (“VIX”) products, and adjudicates disciplinary actions. Real-time market monitoring is performed by	See deficiency and recommendations below.

⁸ This column contains: (1) deficiency findings where the Division believes the Exchange was not in compliance with a Commission regulation and must take corrective action and (2) recommendations where the Division identifies areas for improvement.

⁹ Commission regulation 38.151(b) was not reviewed directly because this review focused on regulations related to trade practice surveillance. The Division’s review would have been expanded to cover 38.151(b) if relevant issues had been identified in the course of reviewing other subparts of 38.151 or other regulations.

¹⁰ See CFE Rule 308.

¹¹ See CFE Rules 601-620.

	<p>the CFE Help Desk (“Help Desk”), which monitors alerts pertaining to unusual price movements, trading volume, and market conditions, and identifies potential market disruptions or abnormalities to CFER.¹² As discussed in further detail below, the Exchange, through its Chief Regulatory Officer (“CRO”), supervises NFA.</p> <p><u>CFER Organization and Staffing During the Target Period and Thereafter</u></p> <p>At the beginning of the target period, CFER consisted of nine full-time staff members¹³ and two open positions. All of the investigators reported to the CFE Director, who, in turn, reported to the CRO. During the target period, CFER experienced a number of staffing and organizational changes, including the departure of four staff members, and the hiring of six full-time staff members, one of which included the newly-created Enforcement Director position. By the end of the target period, CFER consisted of 14 full-time staff members¹⁴ and two part-time interns. Additionally, the investigators were reorganized into three groups, each of which was led by a Chief Investigator.¹⁵ The Chief Investigators reported directly to the CFE Director, who in turn, reported to the CRO.</p> <p>After the target period, in September 2015, the CRO who had been dedicated solely to CFE since 2012 was replaced with the CRO from the Chicago Board Options Exchange (“CBOE”).¹⁶ A Deputy CRO was also brought on at this time. During this time, CFER also lost an additional three investigators. In</p>	
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¹² During the target period, the CFE Help Desk included three analysts that reported to a CFE Help Desk management team.

¹³ The nine full-time CFER staff members included the CRO, a director, five investigators, one financial surveillance examiner, and one regulatory analyst.

¹⁴ The 14 full-time CFER staff members included the CRO, a director, an Enforcement Director, nine investigators, one financial surveillance examiner, and one regulatory analyst.

¹⁵ Each group was responsible for reviewing referrals made to the Exchange by NFA and conducting audit trail enforcement reviews. Additionally, each group was assigned specific type of surveillance matters.

¹⁶ Both CFE and CBOE are wholly-owned subsidiaries of CBOE Holdings, Inc.

	<p>January 2016, CFER consisted of 13 full-time staff members and one open Vice President position.¹⁷</p> <p>In March 2016, the CFER underwent another reorganization, in which it created two manager positions that would each supervise a chief investigator and team of three investigators. The managers were charged with managing the day-to-day activities of the regulatory program, including conducting supervisory review of the investigations. The former CFE Director was promoted to a Managing Director, and was tasked with overseeing the CFER program, including supervising the managers, and managing CFE’s day-to-day interactions with NFA. At this time, CFER consisted of 14 full-time employees,¹⁸ one intern, and two open chief investigator positions. At the time, the CRO dedicated less than 50 percent of his time to CFE matters, while the Deputy CRO dedicated approximately 50 percent (or more) of her time to CFE matters. The remaining individuals were fully dedicated to CFE.</p> <p>Given that the CRO and the Deputy CRO both hold their respective titles at CBOE and CFE, the Division is concerned that a number of factors could potentially affect the workload of the CRO and Deputy CRO, such as an increase in volume or the number of products traded at either CBOE or CFE.</p> <p><u>NFA Organization Staffing During the Target Period</u></p> <p>During the target period, NFA’s Market Regulation Department consisted of the DCM Surveillance Group, SEF Surveillance Group, and a FOREX Group. The DCM Group, which provided regulatory services for a total of five exchanges (including CFE), consisted of ten staff members.¹⁹ Each exchange was assigned an “Exchange Lead” that had primary responsibility for daily</p>	<p><u>Recommendation</u></p> <p>The Exchange should evaluate the workload of the CRO and the Deputy CRO on an ongoing basis to ensure that they are able to allocate sufficient time and resources to the CFE regulatory program.</p>
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¹⁷ The 13 full-time CFER staff members included the CRO, Deputy CRO, CFE Director, Enforcement Director, seven investigators, one financial surveillance examiner, and one regulatory analyst.

¹⁸ The 14 full-time CFER staff members included the CRO, Deputy CRO, a Managing Director, Enforcement Director, two managers, six investigators, one financial surveillance examiner, and one regulatory analyst.

¹⁹ The ten NFA staff members included a Vice President, Director, Senior Manager, two Managers, four analysts, and an examiner.

	<p>surveillance of the assigned exchange’s market and attending monthly meetings with the exchange. The Exchange Lead for CFE spent approximately eight to nine hours a day solely on CFE matters. In the event that workload increased, as it did when the Exchange experienced a large spike in messaging volume in 2014, additional NFA staff was available to assist the Exchange Lead. Additionally, two managers were available at all times to provide the Exchange Lead with back-up assistance.</p> <p><u>Sufficiency of Staffing During the Target Period</u></p> <p>As part of its obligation to monitor the sufficiency of its compliance staff resources, CFE may take into consideration the staffing resources of NFA in addition to the Exchange’s own staff.²⁰ Accordingly, the Division found that the number of CFE and NFA staff dedicated to performing trade practice surveillance at the end of the target period was sufficient. However, the considerable amount of staff turnover during the target period prevented the Exchange from maintaining, on a consistent basis, sufficient compliance staff to conduct and complete investigations in a timely manner,²¹ as required by Commission regulation 38.155(a).</p> <p>The Division recognizes that the Exchange took steps during the target period and thereafter to address staff turnover, including contracting with a third-party consultant during the target period to streamline the flow of work to develop a better working environment for CFE staff. Upon its review, the third-party consultant made various recommendations to enhance CFE’s documentation of its processes and training programs, as well as replacing CFE’s existing case tracking system. The CRO also raised concerns about staffing turnover to the Human Resources Department and was told that a compensation study conducted in 2012 indicated that CFE’s salaries were competitive. Most recently, the Exchange has focused on providing additional training and learning opportunities for all CFE staff.</p>	<p><u>Deficiency Requiring Corrective Action</u></p> <p>As required by Commission regulation 38.155(a), the Exchange must establish and maintain sufficient compliance department resources and staff to ensure it can conduct its self-regulatory functions, including completing investigations in a timely manner.</p> <p><u>Recommendation</u></p> <p>CFE should continue to examine the underlying reasons for the large number of staff departures over the target period and thereafter. The Exchange should consider conducting a further compensation study to determine whether CFE is offering competitive compensation and benefits to attract and retain qualified investigators as compared to its peers in the derivatives</p>
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²⁰ Core Principles and Other Requirements for Designated Contract Markets, 77 FR 33612, 36628 (June 19, 2012).

²¹ The Division’s analysis concerning the timeliness of the investigations is addressed below in 38.158.

	<p>The Division found that the CRO did not participate in the formulation of the 2012 compensation study and did not receive a copy of the study. Likewise, it does not appear that the Regulatory Oversight Committee (“ROC”) was made aware of this study. The Division is concerned that this study was not shared despite the fact that it contained information that was essential for the CRO in evaluating the sufficiency of compliance resources under Commission regulation 38.155, and for the ROC in reviewing the compensation of regulatory personnel, as required by the ROC charter and identified by the Commission in the Acceptable Practices under Core Principle 16.²²</p>	<p>industry. CFE should ensure that the CRO and ROC are fully engaged in efforts to attract and retain qualified staff.</p>
<p>§ 38.156 Automated trade surveillance system</p>	<p>NFA uses its own proprietary automated system, Webfocus, to conduct trade practice surveillance on behalf of the Exchange. This surveillance includes monitoring for the following types of trade practice-related transactions: Trading Ahead, Front Running, Direct/Indirect Crossing, Direct/Indirect Taking the Other Side, Wash Trading, Pre-Arranged Trading, Direct/Indirect Money Passing, Counter-Party Trade Percentage, Marking the Close, and Spoofing.</p> <p>NFA staff uses the following Webfocus tools to conduct trade practice surveillance:</p> <ul style="list-style-type: none"> • <u>Exceptions (Aggregate and Non-Aggregate)</u> – specific parameters such as time, order sequence, CTI code, firm/trader/account ID and order/trade size are utilized to create trade exceptions. Exceptions are generated daily and are reviewed on a trade day plus one (T+1) basis. • <u>Alerts</u> – alerts are created based on specified trade activity and can be generated at the firm, trader, or account level. The primary focus of an alert is to notify staff of certain activity or circumstances that may require follow-up. Alerts are generated daily and are reviewed on a T+1 basis. • <u>Ad-Hoc Queries</u> – these queries are not based on Exceptions or Alerts 	<p>See recommendation below.</p>

²² See Acceptable Practice for Core Principle 16 (Conflicts of Interest), Appendix B, Part 38.

	<p>and can be created on an as-needed basis. Typically used, for example, to review large block trades and cancellation rates.</p> <ul style="list-style-type: none"> • <u>Profiles</u> – NFA has created various Profiles at the Exchange, trader, firm, and account levels. Profiles provide staff with the ability to determine patterns of trade activity over specific timeframes. <p>NFA reviews the exception parameters on a quarterly basis. The broad parameters are set forth in the Regulatory Services Agreement (“RSA”) between NFA and the Exchange, and are generally the same for all exchanges for which NFA provides regulatory services. Per the RSA, CFE conducts an annual audit of services provided by NFA, which includes a review of exception and alert parameters. During the target period, the Exchange engaged an external audit firm to conduct an examination of NFA to validate the integrity and the accuracy of the surveillance system that NFA utilizes to detect the trade exceptions described within the RSA and NFA’s Market Regulation Procedures. The results of this examination revealed that six of the 12 exception types tested, for which tests scenarios were submitted, did not generate an expected exception. Most, if not all of these specific surveillance reports regularly generate trade exceptions on a T+1 basis or have generated exceptions at some other frequency. A review of the test scenario results by CFE and NFA determined that exceptions which were not generated were primarily due to the test scenarios not configured based off of the specific surveillance logic.²³</p> <p>As part of its quarterly review of exception parameters, the Division encourages NFA to take into account, among other things, the Exchange’s products and volume in making any necessary adjustments to ensure the exception parameters are accurately and adequately flagging trading activity for review.</p> <p>In addition to the Webfocus tools described above, the Exchange also uses the following proprietary tools to conduct trade practice surveillance:</p>	<p><u>Recommendation</u></p> <p>In conducting its review of the parameters of its automated surveillance system, NFA should consider whether exception parameters should be customized for CFE’s markets.</p>
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²³ See 38.154 for further discussion.

	<ul style="list-style-type: none"> • <u>Market Replay</u> – a graphical user interface that allows staff to view and query current and past orders, quotes, and trades in order to reconstruct the sequence of market activity on CBOE, CFE and C2 Options Exchange (“C2”).²⁴ Market Replay data is populated on a near real-time basis and provides historical CFE data going back five years. The Exchange has provided NFA access to Market Replay in order to view all CFE order and trade history. • <u>Web-based Surveillance (“WBS”)</u> – a proprietary web-based surveillance system for CBOE, CFE and C2. Used by CFE to conduct cross-market trade practice surveillance, market surveillance and audit trail reviews. 	
<p>§ 38.153 Capacity to detect and investigate rule violations</p>	<p><u>Detecting Rule Violations</u></p> <p>NFA utilizes the surveillance tools described above to detect the following types of possible violative trading activity:</p> <ul style="list-style-type: none"> • <u>Trading Ahead of Customer Orders</u>: instances in which transactions are executed for proprietary accounts before a customer order is executed. • <u>Trading Against Customer Orders</u>: instances in which a trader assigns a trade to a personal account that was ineligible for assignment or otherwise properly and directly takes the opposite side of a customer’s order. • <u>Accommodation/Non-Competitive Trading</u>: seeks to identify communications between market participants for the purpose of discerning interest in the execution of a transaction prior to the exposure of the order to the market. 	<p>No deficiencies or recommendations.</p>

²⁴ C2 Options Exchange is a wholly-owned subsidiary of CBOE Holdings, Inc.

	<ul style="list-style-type: none"> • <u>Improper Cross Trading</u>: transactions where a trader takes the opposing side of a brokered trade into his own or a proprietary account. • <u>Front Running</u>: transactions where a trader takes advantage of knowledge of an order about to be placed on the market. This is accomplished by entering an order and executing a trade with the intention of trading without or at reduced market risk. • <u>Wash Trading</u>: transactions involving the same participant and account on both sides of the transaction. • <u>Pre-Arranged Trading</u>: transactions that occur between traders at an agreed upon price and where both sides are entered into the system within a specific period of time. • <u>Money Passing</u>: transactions made for the purpose of transferring funds between accounts. • <u>Stop Order Fishing</u>: transactions at prices that may trigger resting stop orders resulting in artificial market movement. • <u>Marking the Close</u>: transactions at prices that misalign or misrepresent the market in a time window that is too near the close for arbitrageurs to realign their positions. • <u>Spoofing I and II</u>: situations where a trader places a large order in an effort to induce the market to hit a resting order. This type of activity distorts the balance of bids/offers resulting in unfair pricing, causing a reaction from market participants. While Spoofing I surveils for a specified period of time, Spoofing II enables NFA staff to expand the scope of their review and filter based on size, time period, firm, trader (to include review of other traders or order activity surrounding suspicious activity), and the duration of time that the order remained in the market. NFA is also currently testing a “layering and laddering” surveillance tool, which would seek to identify instances where 	
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	<p>multiple orders at the same price points could create an imbalance in the market. Finally, NFA is testing an exception that would surveil for “flipping,” which entails the review of market participants “switching” from one side of the market to other, perhaps creating the appearance of inaccurate pricing and volume.</p> <p>In addition to the surveillance conducted by NFA for the trading activity described above, in April 2015, the Exchange developed its own proprietary VIX Manipulation Tool. The Exchange has also developed a Cross-market Spoofing tool that is currently being enhanced and is planning to develop a Cross-market Frontrunning tool.</p> <ul style="list-style-type: none"> • <u>VIX Manipulation Tool</u>: utilizes CBOE market data to review for potential manipulation of the volatility indices. Exceptions are generated on a monthly basis at contract expirations. • <u>Cross-market Spoofing Tool</u>: utilizes both Exchange data and options data from CBOE to identify potential spoofing activity on both markets. • <u>Cross-market Frontrunning Tool</u>: utilizes both Exchange data and options data from CBOE to identify futures trades that may be front running options transactions. <p><u>Collecting Information and Documents</u></p> <p>Rule 308 gives the Exchange the authority to require cooperation and participation in the investigatory and disciplinary processes of any person initiating or executing a transaction on or subject to the rules of the Exchange directly or through an intermediary, and any person for whose benefit such a transaction has been initiated or executed. Under Rule 702, each TPH and related party must furnish information requested by the Exchange in connection with an investigation or proceeding.²⁵</p>	
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²⁵ See CFE Rule 702.

<p>§ 38.158 Investigations and investigation reports</p>	<p><u>NFA Investigative Procedures</u></p> <p>NFA’s investigative procedures are documented in the Market Regulation Procedures for DCMs. These procedures provide that NFA may initiate an investigation from a number of sources, including trade or aggregate exceptions generated through NFA surveillance, off-exchange transaction reviews, proactive reviews based on overall market or trade practice surveillance, customer or trader complaints, exchange requests, or randomly selected trade activity. In most instances, NFA will immediately initiate an investigation if a review of the audit trail data indicates that an exchange rule may have been violated. However, for randomly-selected trading activity, such as Exchange for Related Positions (“EFRP”) and block trade reviews, NFA will initiate an investigation for a sample of selected trades at the end of the month for further review. Once the investigation is initiated, NFA staff will contact the parties involved in the activity under review to obtain the facts surrounding the trading.</p> <p>If NFA staff’s review indicates that a potential rule violation may have occurred, an Investigative Summary is prepared recommending that the Exchange review trading activity in conjunction with specified rule(s) for potential disciplinary action. NFA does not, however, recommend potential disciplinary action nor does it recommend what type of disciplinary action is appropriate for the trading activity under review. All Investigative Summaries include the following components, as applicable: the reason(s) initiated; summary of the complaint; relevant facts of the trade activity under review; staff analysis; expansion of review period; summary conclusion; recommendation; and disciplinary history of the parties under review. Investigative Summaries are reviewed, signed and dated by a Manager or a Senior Manager and the Associate Director.</p> <p>If the findings do not indicate a potential rule violation, a closure memo is prepared for the Exchange’s review and the matter is closed administratively. Matters that are closed administratively follow the same review and approval procedures described above for Investigative Summaries, with the addition that the CFE CRO also signs the closure memos.</p>	<p>See deficiency and recommendations below.</p>
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	<p><u>CFE Investigative Procedures</u></p> <p>Once NFA has completed its referral, CFE is notified via email that the referral is available through the electronic “Secure Box” that NFA provides the Exchange. The referral is entered into the Exchange’s Integrated Case Tracking System (“ICT”), where it is assigned an ICT number and it becomes an investigation. The investigation is then assigned to the appropriate investigative group depending on the type of activity. Investigators review the referral to determine whether NFA’s interpretation of the rules cited is appropriate or additional information is needed.</p> <p>Upon conclusion of the review, CFE staff will summarize the information obtained from the NFA referral, along with any additional information and analysis collected by the Exchange, into an Investigation Report, which includes the reason the investigation was initiated; a summary of the complaint, if any; the relevant facts; CFE and NFA staffs’ analysis and conclusions; and a recommendation as to whether disciplinary action should be pursued. The Investigation Report is then reviewed by both the Chief Investigator and the Manager before it is presented to the CRO during a weekly department meeting, which is attended by all CFE staff, for further discussion and approval. The CRO may approve the Investigation Report and the recommended disposition at this time or remand the investigation to staff to gather more information or conduct additional analysis.</p> <p>Although CFE maintains a CFE Investigation and Procedures Manual (“Compliance Manual”), the Division found that the investigative procedures described above were not well-documented and do not address, among other things, the following: (1) investigative procedures CFE follows in performing any surveillance activities not conducted by NFA; (2) procedures for reviewing referrals from NFA; (3) procedures for drafting the Investigation Report; and (4) the supervisory review process of the Investigation Report.</p> <p><u>Complaint Procedures</u></p> <p>Complaints are received from internal sources, such as the Help Desk; or external sources, such as TPHs, firms, or customers. Once received, complaints are logged and tracked by the Exchange’s ICT System, and the</p>	<p><u>Recommendation</u></p> <p>The Exchange should update its Compliance Manual to ensure that, at a minimum, the following investigative procedures are well-documented: (1) investigative procedures CFE follows in performing any surveillance activities not conducted by NFA; (2) procedures for reviewing referrals from NFA; (3) procedures for drafting the Investigation Report upon review of referrals from</p>
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	<p>matter is referred to NFA for further review. NFA reviews trade and order data, retains audio data, and sends information requests as necessary to verify the facts alleged in the complaint. NFA will also review prior complaints against the parties under review, as well as any prior complaints against other parties for the same type of activity described in the complaint. If the matter also entails options trading activity, NFA staff will request that CFE staff obtain and review that trade data from CBOE. Like investigations, if NFA’s analysis of a complaint indicates that a potential rule violation may have occurred, it will draft an Investigative Summary, in accordance with the procedures described above. For complaints that do not indicate that a potential rule violation may have occurred, NFA staff will close the review administratively. Complainants are notified of the final disposition once it has been made.</p> <p><u>Investigation Logs</u></p> <p>The Exchange provided the Division with an investigation log for all investigations that were opened during the target period. The log included the following information with respect to NFA’s review of the investigations: date that NFA opened the investigation; the NFA Market Regulation Investigation Number (“MINV”) number assigned to the investigation; and the date that NFA closed the investigation. The log also tracked CFE’s review of the investigation, including: the date CFE opened the investigation; the CFE ICT number assigned to the investigation; the date that the investigation was completed; if the matter was referred to the Business Conduct Committee (“BCC”) for disciplinary action, the disposition of the BCC and the date of such disposition; and the date that the file was administratively closed.</p> <p><u>NFA Proactive Reviews Conducted During Target Period</u></p> <p>NFA conducts proactive reviews that are not driven by alerts or exception reports, but rather focused on specific trade or market activity to identify potential patterns, apparent inconsistencies or questionable activity that could suggest a possible rule violation, or in any other instance for which NFA deems additional review of particular trading activity to be appropriate. NFA opened and closed four proactive reviews during the target period, all of which were closed administratively by NFA. Counting from the time that each</p>	<p>NFA; and (4) the supervisory review process of the Investigation Report.</p>
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	<p>proactive review was opened by NFA and ending the date that the proactive review was closed by NFA, the average length of time these proactive reviews were open was 69 days.</p> <p><u>Trade Practice Investigations Opened During Target Period</u></p> <p>The Exchange opened seven trade practice investigations during the target period, one of which was closed during the target period.</p> <p><u>Trade Practice Investigations Closed During Target Period</u></p> <p>The Exchange closed four trade practice investigations during the target period, three of which had been open prior to the target period.</p> <p>Investigations involving cross trades accounted for two of the four investigations closed during the target period. In addition, one investigation involved wash trades and another investigation involved fictitious transactions.</p> <p>Of the four closed investigations, one resulted in a Statement of Charges, one resulted in Letters of Caution²⁶ to two separate TPHs, one was Filed without Action,²⁷ and one was administratively closed by NFA.²⁸</p> <p><u>Timeliness of Trade Practice Investigations</u></p> <p>As noted above, the Exchange closed four trade practice investigations during the target period. Counting from the time each investigation was opened by</p>	
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²⁶ The Exchange uses the term “Letter of Caution” for its warning letters. The Exchange’s policy is to issue a Letter of Caution where a party violates a technical rule for the first time and it appears a letter is sufficient to prevent a recurrence. The Letter of Caution serves as notice that another similar violation will result in a formal disciplinary proceeding. During the target period, Letters of Caution were sent by CFER staff, under delegated authority from the BCC and with approval of the BCC Chairman.

²⁷ The Exchange uses the term “Filed Without Action” to describe a matter that has been closed upon review and approval of CFE management.

²⁸ Matters that are administratively closed by NFA do not require the Exchange’s approval; however, NFA routinely sends a closure memo for the Exchange’s review for all matters that are administratively closed by NFA.

	<p>NFA and ending the date that the investigation was completed by CFER, the average length of time investigations were open was 649 days. One investigation remained open for 211 days, a second investigation remained open for 591 days, a third investigation remained open for 807 days and a fourth investigation remained open for 987 days. The Division did not identify any mitigating circumstances in the three investigations that were open for more than 365 days to justify the length of time that these investigations remained open. Commission regulation 38.158(b) requires that investigations be completed in one year or less, absent mitigating circumstances.</p> <p>Additionally, the Division identified two trade practice investigations that were opened prior to the target period and that remained open after the target period. One investigation remained open for 1010 days, while the other remained open for 534 days. The Division did not find sufficient mitigating circumstances to justify the 1010 days for which one of the investigations remained open.</p> <p>During the review period, the then-CRO addressed the ROC regarding efforts being made to reduce the length of time that investigations remained open. The CRO described the undertakings CFE had already made to improve timeliness of investigations, including hiring additional staff, automating various processes, making improvements to the internal review process, and engaging a third-party consultant to further develop process improvements and further utilize existing workflow management tools.</p> <p>The Division believes that several factors contributed to the delay in completing investigations during the target period, including high staff turnover, increased workload due to an influx of NFA referrals related to Exchange of Contract for Related Position (“ECRP”) surveillance, and lack of effective communication with NFA, as discuss further under Commission regulation 38.154. Additionally, under the organizational structure of CFER during the target period, all of the investigators reported to one manager during the target period, which led to delays in completing supervisory review of the investigations. Recognizing these challenges, CFE undertook a number of changes during the target period and thereafter to remediate the delay in completing investigations, including reorganizing CFER to improve the workflow of investigations and the supervisory review process; establishing</p>	
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	<p>new procedures for NFA for conducting ECRP reviews in an efficient and timely manner; and working with NFA to enhance the format and content of the referrals to improve the efficiency with which the Exchange can review these referrals.</p> <p>The Division has stated in previous rule enforcement reviews that when a significant period of time elapses between the relevant conduct and the date that the investigation was closed (or referred to enforcement), problematic behavior may continue without being sanctioned, which makes repeated transgressions more likely to occur.²⁹</p> <p><u>Adequacy of Investigations</u></p> <p>Division staff reviewed the four investigations that were closed during the target period, as well as a sample of investigations that were completed in the year subsequent to the target period. Subject to the deficiency identified above with respect to Commission regulation 38.158(b) (timeliness of investigations) and the recommendation below regarding the Exchange’s decision not to pursue disciplinary action, the Division found the quality of the investigative work in the investigations reviewed to be thorough and complete.</p> <p>The Division identified two investigations—one that was closed during the target period and that was closed one after—in which it found the Exchange’s decision not to pursue disciplinary action was inappropriate. Both of these investigations involved the execution of test trades in the live trading environment.</p> <p>In the first investigation, a TPH submitted four trades—buy and sell orders both for two different contracts. While the TPH represented that it did not intend to cross the orders, the orders were placed close in time to one another to minimize the difference in price between the resulting buy and sell trades that might otherwise result from price fluctuation over time. The accounts then sold back the positions the following day after the TPH confirmed the clearing</p>	<p><u>Deficiency Requiring Corrective Action</u></p> <p>As required by Commission regulation 38.158(b), the Exchange must complete investigations in one year or less, absent mitigating circumstances.</p>
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²⁹ Trade Practice Rule Enforcement Review of The New York Mercantile Exchange and The Commodity Exchange, November 21, 2014.

	<p>and settlement processes functioned properly. The Exchange issued a Letter of Caution for violations of Rules 614 (Pre-Arranged Trades), 608 (Just and Equitable Principles of Trade) and 602 (Fictitious Transactions).</p> <p>In the second investigation, a clearing TPH contacted the CFE API Group regarding a one-lot order that was placed by one of its customers to test the trade stream from beginning to end. The order was placed off the market (four-ticks below the best bid), but the clearing TPH indicated that its customer would have accepted the trade if the order had traded. The Exchange concluded the test order was a fictitious order since it was not bona-fide, and issued a Letter of Caution citing to a number of reasons, including that: (1) it was de minimus activity that did not appear to affect the market or other market participants; (2) this was the first instance that the TPH had engaged in a fictitious transaction; and (3) it was not clear that the TPH was made aware of the test trade environment by the Exchange’s API Group. The Exchange also issued a Letter of Caution to the clearing TPH for failure to administer reasonable supervisory procedures.</p> <p>Based on the fact that the Exchange concluded that the subject TPHs knowingly placed fictitious orders and trades in violation of the Exchange’s rules, the Division believes that the Exchange should have pursued disciplinary action in these instances. While a warning letter may be appropriate for certain violations of recordkeeping or audit trail rules, the Division believes that issuing a warning letter for a substantive trading violation is never appropriate.</p> <p><u>Warning Letters</u></p> <p>As noted above, of the four trade practice investigations closed during the target period, one investigation resulted in Letters of Caution to two separate TPHs. The Division found that the Exchange did not issue more than one warning letter to these entities for the same violation within a twelve month period.</p>	<p><u>Recommendation</u></p> <p>CFER should recommend and the Exchange should promptly take appropriate disciplinary action when it makes a finding that a violation of a substantive trading rule occurred.</p>
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<p>§ 38.154 Regulatory services provided by a third party</p>	<p><u>NFA Compliance Staff and Coordination with CFE</u></p> <p>The Exchange holds monthly meetings with NFA to discuss ongoing investigations, trading activity, market participants, large trader issues, incentive programs and market makers, and other matters of regulatory concern. Once a quarter, these meetings are conducted in person. NFA staff also attends the Exchange’s ROC meetings when requested by CFE. With regard to ongoing investigations, the Exchange and NFA also communicate on a more informal, as-needed basis. NFA copies the Exchange on all emails sent on the Exchange’s behalf through the course of an investigation.</p> <p>During the target period, the Exchange and NFA held periodic meetings and engaged in informal discussions about ongoing investigations and other matters of regulatory concern. However, it is not apparent from the Division’s review of the investigations that such discussions were always effective. For example, in three of the four investigations that were closed during the target period, the Division found that the Exchange either disagreed with the potential rule violations cited by NFA in its referral or considered additional potential violations that may or may not have ultimately been found to have occurred. The Exchange took 449 days after it received the referral from NFA to complete one of these investigations, 629 days to complete the second investigation, and 798 days to complete the third investigation.</p> <p>As a threshold matter, the Division expects exchanges to thoroughly review the investigatory work conducted by their RSP and acknowledges that during such review exchanges should query whether the rule violations identified by their RSP are appropriate, or whether there are additional potential rule violations that should be considered. However, the Division believes that such a review should not occur at the expense of completing an investigation in a timely manner. If an exchange and its RSP are effectively communicating, on a routine basis, regarding ongoing investigations and matters of regulatory concern, then such conversations may address certain issues affecting the ultimate disposition of the investigation, such as identifying which rules may have been violated prior to the exchange’s receipt of a referral from its RSP. It is the Division’s view that the Exchange could have reviewed NFA’s investigatory work in a quicker, more efficient manner—and, as a result, could</p>	<p><u>Deficiency Requiring Corrective Action</u></p> <p>As required by Commission regulation 38.154(b), the Exchange must supervise the quality and effectiveness of the services provided by its third-party regulatory service provider, NFA. As part of the regular meetings with NFA, the Exchange must ensure that it adequately discusses “<i>ongoing investigations</i>, trading patterns, market participants, <i>and any other matters of</i></p>
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	<p>have potentially completed investigations in a more timely manner—if the Exchange and NFA had engaged in clearer, more effective discussions regarding ongoing investigations and other matters of regulatory concerns.</p> <p>The Division encourages the Exchange to improve its documentation of the meetings and communications with NFA so that both parties are clear as to the basis for either NFA’s or the Exchange’s recommendation or disposition on a matter. Such information can also be used by both the Exchange and NFA as a reference when questions regarding similar matters arise.</p> <p>As discussed above, as part of the Exchange’s responsibility to review the adequacy and effectiveness of the regulatory services provided by NFA, the Exchange engaged a third-party consultant during the target period to review NFA’s programs, policies, and procedures, and to evaluate NFA’s surveillance by submitting a deck of test trade data that was designed to generate surveillance exceptions. A review of the test scenario results by CFE and NFA determined that exceptions which were not generated were primarily due to the test scenarios not configured based off of the specific surveillance logic. CFE plans to use the CBOE Internal Audit Group to perform these reviews in the future, and will focus primarily on reviewing the controls NFA’s surveillance program has in place. The Division encourages the Exchange to develop reviews of NFA that are better designed to assess the adequacy and effectiveness of the regulatory services provided by NFA.</p> <p><u>Documentation of Regulatory Decisions Required by the RSA</u></p> <p>CFE’s RSA with NFA specifies that if CFE disagrees with NFA’s recommendation relating to an investigation or if CFE’s recommendation differs in any respect from NFA’s recommendation then CFE shall notify NFA in writing of this decision along with an explanation as to why CFE disagrees with NFA’s recommendation.</p> <p>The Division reviewed the investigation files for documentation for any instance where the Exchange did not take action with respect to a potential rule violation identified by NFA. The Division found that in three investigations, CFE did not document and share instances where it was not taking action with</p>	<p><i>regulatory concern”</i> (emphasis added).</p> <p>The Exchange should improve its documentation of the meetings and communications with NFA to ensure that all substantive discussions that affected either NFA or the Exchange’s recommendation or disposition on a matter are captured.</p>
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	<p>respect to a potential rule violation identified by NFA. For those investigations in which CFE did provide an explanation as to why it disagreed with NFA, such explanation was typically very brief and did not provide adequate detail to fully explain the Exchange’s rationale for not taking action.</p> <p>The Division also reviewed the investigation files for documentation for any instances where the Exchange finds additional potential rule violations from what was identified by NFA in its referral. The Division found three investigations in which the Exchange did not document and share with NFA instances where it found additional potential rule violations.</p> <p>The Division believes it is incumbent on any exchange that utilizes a third-party RSP to effectively communicate its expectations regarding the services to be performed by the RSP and provide helpful feedback when necessary to ensure the adequacy and effectiveness of the regulatory services provided by its RSP. The Exchange’s RSA requires documentation of any instances where the Exchange’s recommendation “differs in any respect from NFA’s recommendation.” Furthermore, Commission regulation 38.154(c) not only requires DCMs to document any instances where its actions differ from those recommended by its RSP, but also requires exchanges to include “the reasons why the [DCM] chose a different course of action.”</p>	<p><u>Recommendation</u></p> <p>CFE should document and share with NFA all instances where the Exchange’s actions differ from those recommended by NFA. Such documentation should adequately explain how the Exchange’s recommendation differs in any respect from NFA’s recommendation.</p>
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Appendix B

CFE RULE ENFORCEMENT REVIEW TABLE OF CORE PRINCIPLES AND REGULATIONS REVIEWED

§38.150 Core Principle 2.

(a) In general. The board of trade shall establish, monitor, and enforce compliance with the rules of the contract market, including:

(1) Access requirements;

(2) The terms and conditions of any contracts to be traded on the contract market; and

(3) Rules prohibiting abusive trade practices on the contract market.

(b) Capacity of contract market. The board of trade shall have the capacity to detect, investigate, and apply appropriate sanctions to any person that violates any rule of the contract market.

(c) Requirement of rules. The rules of the contract market shall provide the board of trade with the ability and authority to obtain any necessary information to perform any function described in this section, including the capacity to carry out such international information-sharing agreements, as the Commission may require.

§ 38.151 Access requirements.

(a) Jurisdiction. Prior to granting any member or market participant access to its markets, a designated contract market must require that the member or market participant consent to its jurisdiction.

...

(c) Limitations on access. A designated contract market must establish and impartially enforce rules governing denials, suspensions, and revocations of a member's and a person with trading privileges' access privileges to the designated contract market, including when such actions are part of a disciplinary or emergency action by the designated contract market.

§38.152 Abusive trading practices prohibited.

A designated contract market must prohibit abusive trading practices on its markets by members and market participants. Designated contract markets that permit intermediation must prohibit customer-related abuses including, but not limited to, trading ahead of customer orders, trading against customer orders, accommodation trading, and improper cross trading. Specific trading practices that must be prohibited by all designated contract markets include front-running, wash trading, pre-arranged trading (except for certain transactions specifically permitted under part 38 of this chapter), fraudulent trading, money passes, and any other trading practices that a designated contract market deems to be abusive. In addition, a designated contract market also must prohibit any other manipulative or disruptive trading practices prohibited by the Act or by the Commission pursuant to Commission regulation.

§38.153 Capacity to detect and investigate rule violations.

A designated contract market must have arrangements and resources for effective enforcement of its rules. Such arrangements must include the authority to collect information and documents on both a routine and non-routine basis, including the authority to examine books and records kept by the designated contract market's members and by persons under investigation. A designated contract market's arrangements and resources must also facilitate the direct supervision of the market and the analysis of data collected to determine whether a rule violation occurred.

§38.154 Regulatory services provided by a third party.

(a) Use of third-party provider permitted. A designated contract market may choose to utilize a registered futures association or another registered entity, as such terms are defined under the Act, (collectively, “regulatory service provider”), for the provision of services to assist in complying with the core principles, as approved by the Commission. Any designated contract market that chooses to utilize a regulatory service provider must ensure that its regulatory service provider has the capacity and resources necessary to provide timely and effective regulatory services, including adequate staff and automated surveillance systems. A designated contract market will at all times remain responsible for the performance of any regulatory services received, for compliance with the designated contract market's obligations under the Act and Commission regulations, and for the regulatory service provider's performance on its behalf.

(b) Duty to supervise third party. A designated contract market that elects to utilize a regulatory service provider must retain sufficient compliance staff to supervise the quality and effectiveness of the services provided on its behalf. Compliance staff of the designated contract market must hold regular meetings with the regulatory service provider to discuss ongoing investigations, trading patterns, market participants, and any other matters of regulatory concern. A designated contract market also must conduct periodic reviews of the adequacy and effectiveness of services provided on its behalf. Such reviews must be documented carefully and made available to the Commission upon request.

(c) Regulatory decisions required from the designated contract market. A designated contract market that elects to utilize a regulatory service provider must retain exclusive authority in decisions involving the cancellation of trades, the issuance of disciplinary charges against members or market participants, and the denials of access to the trading platform for disciplinary reasons. A designated contract market may also retain exclusive authority in other areas of its choosing. A designated contract market must document any instances where its actions differ from those recommended by its regulatory service provider, including the reasons for the course of action recommended by the regulatory service provider and the reasons why the designated contract market chose a different course of action.

§38.155 Compliance staff and resources.

(a) Sufficient compliance staff. A designated contract market must establish and maintain sufficient compliance department resources and staff to ensure that it can conduct effective audit trail reviews, trade practice surveillance, market surveillance, and real-time market monitoring. The designated contract market's compliance staff also must be sufficient to address unusual

market or trading events as they arise, and to conduct and complete investigations in a timely manner, as set forth in §38.158(b) of this part.

(b) Ongoing monitoring of compliance staff resources. A designated contract market must monitor the size and workload of its compliance staff annually, and ensure that its compliance resources and staff are at appropriate levels. In determining the appropriate level of compliance resources and staff, the designated contract market should consider trading volume increases, the number of new products or contracts to be listed for trading, any new responsibilities to be assigned to compliance staff, the results of any internal review demonstrating that work is not completed in an effective or timely manner, and any other factors suggesting the need for increased resources and staff.

§38.156 Automated trade surveillance system.

A designated contract market must maintain an automated trade surveillance system capable of detecting and investigating potential trade practice violations. The automated system must load and process daily orders and trades no later than 24 hours after the completion of the trading day. In addition, the automated trade surveillance system must have the capability to detect and flag specific trade execution patterns and trade anomalies; compute, retain, and compare trading statistics; compute trade gains, losses, and futures-equivalent positions; reconstruct the sequence of market activity; perform market analyses; and support system users to perform in-depth analyses and ad hoc queries of trade-related data.

§38.158 Investigations and investigation reports.

(a) Procedures. A designated contract market must establish and maintain procedures that require its compliance staff to conduct investigations of possible rule violations. An investigation must be commenced upon the receipt of a request from Commission staff or upon the discovery or receipt of information by the designated contract market that indicates a reasonable basis for finding that a violation may have occurred or will occur.

(b) Timeliness. Each compliance staff investigation must be completed in a timely manner. Absent mitigating factors, a timely manner is no later than 12 months after the date that an investigation is opened. Mitigating factors that may reasonably justify an investigation taking longer than 12 months to complete include the complexity of the investigation, the number of firms or individuals involved as potential wrongdoers, the number of potential violations to be investigated, and the volume of documents and data to be examined and analyzed by compliance staff.

(c) Investigation reports when a reasonable basis exists for finding a violation. Compliance staff must submit a written investigation report for disciplinary action in every instance in which compliance staff determines from surveillance or from an investigation that a reasonable basis exists for finding a rule violation. The investigation report must include the reason the investigation was initiated; a summary of the complaint, if any; the relevant facts; compliance staff's analysis and conclusions; and a recommendation as to whether disciplinary action should be pursued.

(d) Investigation reports when no reasonable basis exists for finding a violation. If after conducting an investigation, compliance staff determines that no reasonable basis exists for finding a violation, it must prepare a written report including the reason(s) the investigation was

initiated; a summary of the complaint, if any; the relevant facts; and compliance staff's analysis and conclusions.

(e) Warning letters. No more than one warning letter may be issued to the same person or entity found to have committed the same rule violation within a rolling twelve month period.

§38.650 Core Principle 12.

The board of trade shall establish and enforce rules:

- (a) To protect markets and market participants from abusive practices committed by any party, including abusive practices committed by a party acting as an agent for a participant; and
- (b) To promote fair and equitable trading on the contract market.

§38.651 Protection of markets and market participants.

A designated contract market must have and enforce rules that are designed to promote fair and equitable trading and to protect the market and market participants from abusive practices including fraudulent, noncompetitive or unfair actions, committed by any party. The designated contract market must have methods and resources appropriate to the nature of the trading system and the structure of the market to detect trade practice and market abuses and to discipline such behavior, in accordance with Core Principles 2 and 4, and the associated regulations in subparts C and E of this part, respectively. The designated contract market also must provide a competitive, open and efficient market and mechanism for executing transactions in accordance with Core Principle 9 and the associated regulations under subpart J of this part.