

**RULE ENFORCEMENT REVIEW  
OF THE  
MINNEAPOLIS GRAIN EXCHANGE**



**Division of Market Oversight  
August 27, 2009**

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# Rule Enforcement Review of the Minneapolis Grain Exchange

## I. INTRODUCTION

The Division of Market Oversight (“Division”) has completed a rule enforcement review of the market surveillance, audit trail, trade practice surveillance, disciplinary, and dispute resolution programs of the Minneapolis Grain Exchange (“MGEX” or “Exchange”) for compliance with related 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.<sup>1</sup> The review covers the period of October 1, 2006 to June 30, 2008 (“target period”).<sup>2</sup>

The review focused on Core Principle 2, *Compliance with Rules* and Core Principle 12, *Protection of Market participants*, that relates to surveillance, enforcement, and disciplinary procedures used by a contract market to protect market participants from abusive trading practices; Core Principle 4, *Monitoring of Trading*, that relates to an exchange’s program to prevent manipulation, price distortion, and disruption of the delivery or cash settlement process; Core Principle 5, *Position Limitations or Accountability*, that relates to an exchange’s program

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

<sup>2</sup> The original target period for the Exchange was October 1, 2006 to September 30, 2007. It was expanded through June 30, 2008, to accommodate the review of the Exchange’s audit trail program for electronic orders as a result of the Exchange’s announcement on October 24, 2008, to close its trading floor effective December 19, 2008, and transitioning exclusively to electronic trading for all futures trading. (Open outcry trading for options contracts continues to trade in a room located at the Exchange’s headquarters that is separate from the trading floor that closed). The expanded review also allowed the Division to review a larger number of trade practice investigations and disciplinary cases.

for enforcing its speculative position limits and position accountability rules; Core Principle 10, *Trade Information* and Core Principle 17, *Recordkeeping*, that relate to an exchange's audit trail program for recording and safe storage of trade information in a manner which enables prevention of customer and market abuses and enforcement of exchange rules; Core Principle 13, *Dispute Resolution*, that relates to fair and equitable dispute resolution procedures for customers and member-to-member disputes. Appendix B to Part 38 provides acceptable practices for demonstrating compliance with these core principles.<sup>3</sup>

For purposes of this review, Division staff interviewed compliance officials and staff from the Exchange's Department of Audits and Investigations ("A&I"). The Division also reviewed numerous documents used by A&I in carrying out the Exchange's self-regulatory responsibilities. These documents included, among other things, the following:

- computer reports and other documentation used routinely for audit trail enforcement and market and trade practice surveillance;
- audit trail review and trade practice and market surveillance investigation files;
- trade practice investigation, floor surveillance, and disciplinary logs;
- disciplinary case files;
- minutes of disciplinary committee, Board of Directors ("Board") meetings held during the target period; and
- compliance procedures manuals and guidelines.

The Division provided the Exchange an opportunity to review and comment on a draft of

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

this report on July 20, 2009. On August 4, 2009, Division staff conducted an exit conference with MGEX officials to discuss the report's findings and recommendations.

## II. SUMMARY OF FINDINGS AND RECOMMENDATIONS

### A. Compliance Staff

#### Findings

- The Exchange's compliance department, ("A&I"), consists of four staff members: the Director of Market Regulation, two staff investigators, and a part-time administrative assistant. These staff members are responsible for carrying out all of the Exchange's self-regulatory obligations, including market surveillance, floor surveillance, trade practice surveillance, and financial surveillance.
- A&I experienced high turnover with the departure of four staff investigators during and immediately after the close of the target period.
- The high staff turnover contributed to the delay in completing two investigations in a timely manner and conducting prompt interviews in one trade practice investigation.
- Although the Director of Market Regulation has extensive compliance experience, the high turnover of staff investigators in conjunction with a prolonged surge in trading volume and unprecedented price volatility during the target period, placed a significant strain on A&I's ability to perform its multiple daily surveillance activities and fulfill the Exchange's self-regulatory responsibilities.

#### Recommendations

- **MGEX should increase the A&I staffing level to ensure that, among other things, the Exchange can efficiently and effectively perform routine surveillance activities, keep pace with volatile trading periods, and complete investigations in a timely manner, including conducting prompt interviews after a potential trading violation has been detected.**
- **MGEX should examine the underlying reasons for the large number of staff departures over the target period. This examination should include an analysis of the Exchange's budget to ensure that, among other things, competitive compensation and benefits are being offered to retain qualified investigators.**

### B. Market Surveillance

#### Findings

- MGEX maintains an adequate market surveillance program. The Exchange conducts daily market surveillance to identify possible price manipulation or distortion, and to ensure orderly liquidation of expiring contracts.
- The Exchange monitors cash and futures prices, spread and basis relationships, size and ownership of deliverable supply, and size of large trader positions relative to total open interest and deliverable supply. Exchange staff also monitors the bona fide exchange of futures for physicals and exchange of futures for risk transactions.
- The Exchange heightens surveillance of expiring contracts by monitoring potential position concentrations, deliverable supplies, and the relationship between open interest and deliverable supplies.
- The Exchange reviews several large trader reports to analyze large trader activity to monitor positions approaching spot month or all-month speculative limits and to detect potential concentration of positions that could disrupt the market. During the target period, one account exceeded the all-months limit in the hard red spring wheat futures contract for a three-day period. The account holder self-reported the violation to the Exchange and the Commission, and reduced the positions immediately to comply with the speculative limit.
- During the target period, the Exchange opened two investigations to address concerns regarding possible manipulation, including a possible squeeze in the expiring May 2007 hard red spring wheat futures contract. A&I determined there was no evidence to support the claims. The Division found that the investigations were well-documented and included appropriate, well-founded analysis to support their findings.

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

## **C. Audit Trail**

### **Findings**

- The Exchange maintains an adequate audit trail program for open outcry trading. The Exchange conducts an annual audit trail review of each clearing member to evaluate compliance with relevant recordkeeping and submission requirements. Members and clearing firms demonstrated a high rate of compliance with Exchange recordkeeping requirements during the audit trail reviews. The Division found that the audit trail reviews were thorough and well-documented.
- The Exchange requires that members manually record the time of each open outcry trade to the nearest minute. The Exchange uses a computerized verification program to monitor and enforce compliance with the trade timing requirements. The Exchange examines the underlying trade documents as well as time and sales data for members whose timing deficiency level exceeds the daily or monthly timing error thresholds. The

limited number of timing error investigations can be attributed to a high rate of compliance by MGEX members.

- For electronic trading on CME Globex® (“Globex”), the Exchange’s electronic trading platform, the Exchange maintains a complete electronic record of all orders entered and transactions executed, including the terms and time of entry for each order, all order modifications, and all matched trades. This record enables MGEX to reconstruct electronic trading efficiently and effectively. However, the Exchange’s audit trail compliance program does not include a programmatic review of the electronic audit and recordkeeping rules that is comparable in rigor and scope to its review for open outcry trading.
- MGEX has adequate procedures for safe storage of audit trail data. Data is backed-up daily and stored at an off-site back-up storage location. Audit trail data for both electronic and open outcry trades is also simultaneously replicated to the Exchange’s remote data center.

### **Recommendations**

- **The Exchange augment its audit trail compliance program for electronic trading to include a programmatic review of electronic audit and recordkeeping rules that is comparable in rigor and scope to its review program for open outcry trades.**

## **D. Trade Practice Surveillance**

### **Findings**

- The Exchange maintains an adequate trade practice surveillance program. The Time Audit Report and the Broker Error Type Report serve as the Exchange’s automated trade practice surveillance system to identify possible trading practice violations in open outcry and electronic trading.
- A&I conducts daily floor surveillance of open outcry trading during the opening and closing of all contracts and at randomly selected times throughout the trading session.
- MGEX closed 15 investigations during the target period. All of the investigations were well-documented and supported by appropriate analyses. However, two of the investigations were not completed in a timely manner. In addition, in one investigation, the Division found that interviews with potential witnesses were not conducted promptly after the potential trading violation was identified. The Division found that the delays could be attributed to staff turnover, a shift in A&I resources to address two complaints in the wheat market, and heightened surveillance of the wheat market as a result of unprecedented volatility.

### **Recommendations**



- **Take appropriate measures, including hiring additional staff, to ensure that interviews are conducted promptly after a potential trading violation is identified and that investigations are conducted in a timely manner.**

## **E. Disciplinary Program**

### **Findings**

- The Exchange has two disciplinary committees, the Futures Trading Conduct Committee (“FTCC”) and the Business Conduct Committee (“BCC”). The FTCC has jurisdiction over matters concerning futures and option trading, including consideration of possible trading violations, while the BCC has jurisdiction over all other potential violations, such as registration issues, clearinghouse matters, position limits and margins.
- The BCC considered six disciplinary cases and the FTCC considered one disciplinary case during the target period. The Exchange issued fines totaling \$12,750. All seven cases were concluded with settlements. One case involved a member reporting bids that were not bona fide, resulting in a \$10,000 fine and a ten-day suspension.
- Fines ranging from \$250 to \$750 were imposed in six recordkeeping cases. Five of the recordkeeping cases involved firms filing inaccurate position reports with the clearinghouse and/or offsetting positions without the benefit of trade activity, resulting in two \$250 fines and three \$500 fines. One recordkeeping case involved reporting and recordkeeping deficiencies by a member firm, resulting in a \$750 fine. The Division believes larger fines should have been imposed in all six cases.
- Two of the six recordkeeping cases involved repeat offenders. In one case, a clearing member that received a \$500 fine for violating the Exchange’s offset rules also received three separate fines for the same rule violation during the previous six-year period. When evaluating an appropriate sanction, the BCC only considered the member’s prior history for the previous two-year period. In the second case, a clearing member that received a \$250 fine for failing to submit an accurate position report to the clearinghouse received a \$250 fine in 2005 for the identical rule violation.
- A total of 62 staff reminder letters and 16 staff warning letters were issued during the target period. These letters included one reminder letter and three warning letters to the same clearing member during an 11-month period for failing to submit accurate position reports to the clearinghouse.

### **Recommendations**

- **The Exchange’s disciplinary committees should ensure that all sanctions imposed in connection with disciplinary matters are of sufficient magnitude to serve as an effective deterrent.**

- **The Exchange’s disciplinary committees should review a member’s complete disciplinary history when determining appropriate sanctions and impose meaningful sanctions on members who repeatedly violate the same or similar Exchange rules to discourage recidivist activity.**
- **Absent extenuating circumstances, no more than one reminder letter and one warning letter should be issued in a rolling 12-month period before sanctions are imposed.**

## **F. Dispute Resolution Program**

### **Findings**

- Exchange rules provide customers with voluntary procedures for arbitration that are fundamentally fair and equitable. Each party has the right to counsel and each party receives adequate notice of claims presented against them and an opportunity to be heard on all claims, defenses, and counterclaims. MGEX’s arbitration procedures require a prompt hearing and authorize prompt, written, final settlement awards that are not subject to appeal within the Exchange.
- There were no matters submitted for arbitration during the target period.

### **Recommendations**

- **Because there were no requests for arbitration filed during the target period, the Division has no basis upon which to evaluate the adequacy of the Exchange’s dispute resolution program.**

## **III. OVERVIEW OF SIGNIFICANT CHANGES AT THE EXCHANGE SINCE THE DIVISION’S LAST RULE ENFORCEMENT REVIEW**

Since the Division’s last MGEX rule enforcement review in 2004 (and during the 18-month target period), MGEX experienced two significant events: (1) a prolonged surge in trading volume and unprecedented price volatility and (2) a growth in electronic trading that led to the December 19, 2008 closing of its trading floor for all futures trading. These events materially impacted the Exchange’s self-regulatory program and are discussed in detail below.

### **A. Volume Surge and Price Volatility**

MGEX’s total trading volume from December 1, 2002 to December 1, 2003 (the target period for the 2004 Review) was 1,128,253 contracts, an average of approximately 94,021

contracts traded per month. In comparison, from October 1, 2006 to June 30, 2008, the target period for this review, MGEX's total volume was 2,963,752 contracts, an average of 141,131 contracts per month. The Exchange's flagship hard red spring wheat contract accounted for more than 99 percent of the Exchange's trading volume, with 2,963,608 contracts traded for both futures and options.<sup>4</sup>

The significant volume surge at MGEX resulted in numerous Exchange trading records during and immediately after the close of the target period. For example, the trading volume from September 2007 to August 2008, the Exchange's fiscal year, resulted in the all-time volume record for the Exchange with 1,684,439 contracts traded. During this same timeframe, six all-time monthly record trading volumes were set.<sup>5</sup> Additionally, the all-time monthly record for options volume was set in February 2008 with 14,554 contracts traded. The Exchange's all-time open interest record was also set on October 8, 2007 with 76,805 contracts.<sup>6</sup>

In addition to a significant volume surge during the target period, the Exchange's hard red spring wheat futures contract experienced unprecedented price volatility. For example, the December 2007 contract began trading on April 7, 2006, and settled at \$4.38. In comparison, on December 14, 2007, the December contract closed at \$11.30, (158 percent increase from the April 7 settlement price). Additionally, the hard red spring wheat futures contract settled at the

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<sup>4</sup> In addition to the hard red spring wheat contract, the Exchange offers electronic trading for five agricultural index futures and options contracts: National Corn Index ("NCI"), National Soybean Index ("NSI"), Hard Red Spring Wheat Index ("HRSI"), Hard Red Winter Wheat Index ("HRWI"), and Soft Red Winter Wheat Index ("SRWI").

<sup>5</sup> The monthly trading volume records included September, October, and November of 2007 as well as January, February, and August of 2008.

<sup>6</sup> After the close of the target period, the Exchange experienced a decline in trading volume. For example, during the first five months of 2009, the average number of contracts traded per month was 88,472 (37 percent decline from the target period).

limit a total of 71 times and limit moves occurred in the daily trading range a total of 122 times from October 2007 to March 2008.<sup>7</sup>

The Division recognizes that the surge in trading volume and price volatility that occurred during the target period may have been atypical. However, an exchange must have appropriate resources to effectively perform its self-regulatory functions during volatile periods, as well as during any other unusual circumstances. As demonstrated by the numerous records set during the target period, market volatility can last for prolonged periods. Accordingly, for this review, the Division assessed the Exchange's ability to perform its self-regulatory responsibilities under unusual market conditions.

## **B. Shift to Electronic Trading**

The Exchange's total electronic trading volume during the target period was 830,215 contracts, which accounted for approximately 28 percent of the overall volume. During the period from September 2007 to August 2008, electronic trading volume more than doubled from the previous 12-month period. Every month in the September 2007 to August 2008 timeframe placed in the top 20 electronic trading volume months at the Exchange.

On August 1, 2006, MGEX launched side-by-side trading of its hard red spring wheat contract.<sup>8</sup> On January 13, 2008, electronic trading at MGEX shifted from CBOT's electronic platform, e-cbot, to CME's electronic platform, Globex. As noted above, on October 24, 2008, MGEX announced it was closing its trading floor for futures contracts effective December 19,

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<sup>7</sup> In response to the volatility, MGEX, the Kansas City Board of Trade ("KCBT"), and the Chicago Board of Trade ("CBOT") announced an expansion of the price limit for all of the exchanges' respective wheat contracts on February 8, 2008, from 30 cents per bushel to 60 cents per bushel above or below the previous day's settlement price. The price limit expands to 90 cents per bushel on the next trading day if the 60-cent limit is reached.

<sup>8</sup> Previously, the contract only traded electronically during the overnight trading session.

2008, and transitioning all futures trading to Globex.<sup>9</sup> Given that MGEX did not have any electronic trading during the Division's previous rule enforcement reviews, the Division is assessing for the first time the sufficiency of the Exchange's audit trail and trade practice surveillance programs as they relate to electronic trading.

#### **IV. COMPLIANCE STAFF**

##### **A. A&I**

Currently, A&I is headed by the Director of Market Regulation, who reports directly to the President and Chief Executive Officer of the Exchange. The Director was initially employed by MGEX as a staff investigator from 1991 through 1994. During the 1994 to 2005 time period, the Director was employed outside the Exchange by several financial firms. In January 2006, the Director assumed her current position.

The Director is primarily responsible for the oversight and management of MGEX's market surveillance, trade practice surveillance, financial surveillance, audit trail, and disciplinary enforcement programs. These responsibilities include determining whether an investigation should be initiated and the scope of the investigation. Additionally, the Director is responsible for the training and development of A&I staff.

The remainder of A&I staff consists of two staff investigators and a part-time administrative assistant that report to the Director. Staff investigators are responsible for conducting market surveillance, floor surveillance, trade practice surveillance and financial surveillance, and participating in training and development in all aspects of the Exchange's surveillance programs.

During the period from December 2006 to October 2008, the Exchange experienced high turnover with respect to its staff investigators. Over this 23-month period, four staff

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<sup>9</sup> All options open outcry trading continue to trade in a room at the Exchange's headquarters.

investigators left the Exchange. A total of seven investigators have left the Exchange since 2002. The first staff investigator position was held by an employee that left in September 2007 after spending three years at the Exchange. The Exchange filled this vacancy by hiring an employee from the Exchange's Trading Operations Department. However, this investigator resigned from the Exchange in August 2008 after one year in the position. Although the Exchange moved quickly to fill the position by hiring another investigator in September 2008, that investigator departed the Exchange after only three weeks. The current investigator began working for MGEX as a trading floor operations employee in September 2008, and joined A&I as a staff investigator in November 2008. The second staff investigator position was held by an employee that left in December 2006 after spending 17 months at the Exchange. This position is currently occupied by an investigator who has been employed by A&I for more than two years. Prior to her appointment to A&I, this investigator had extensive experience in the futures industry, including seven years of employment at the compliance department of a commodities firm.

The Division believes that the multiple daily surveillance activities that must be performed by A&I staff to meet its self-regulatory responsibilities placed significant strain on A&I during the prolonged volatile market that occurred during the target period. Additionally, as discussed below, the high turnover of staff investigators contributed to delays in completing two trade practice investigations, and in conducting prompt interviews in one of these investigations.<sup>10</sup> The timeliness of both investigations were impacted by the need for A&I to shift its limited resources to conduct heightened surveillance of the wheat market during a period

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<sup>10</sup> Investigations 06-I-33 and 07-I-01 are discussed in detail in Section (VII)(C)(2) on pages 47-49 of this report.

of unprecedented volatility<sup>11</sup> and to address two complaints concerning the liquidation of the May 2007 hard red spring wheat futures contract.<sup>12</sup>

## **B. Conclusions and Recommendations**

The Director of A&I, who has been with the Exchange in this position since January 2006, has significant industry experience. She is assisted in performing her substantive responsibilities by two investigators. Over a 23-month period during and immediately after the close of the target period, four investigators left the Exchange. In addition, the volatile market conditions that occurred during the target period strained A&I's ability to perform its surveillance responsibilities. Specifically, the Division found that staff turnover coupled with the demands placed on A&I by unusual market conditions contributed to delays in completing two trade practice investigations and in conducting timely interviews for one investigation.

Lengthy delays in completing investigations have a deleterious effect on the overall effectiveness on an exchange's rule enforcement program because, among other things, prompt investigation and disciplinary action are necessary to discourage further violations of exchange rules. Therefore, the Division believes that hiring additional staff investigators and reducing staff turnover would enhance the overall effectiveness and efficiency of the Exchange's compliance department, and allow it to meet the demands that can result from unexpected or unusual market conditions. Based on the foregoing, the Division recommends that the Exchange:

- **Increase the A&I staffing level to ensure that, among other things, the Exchange can efficiently and effectively perform routine surveillance activities, keep pace with**

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<sup>11</sup> As is discussed in Section (V)(A)(2) on pages 18-19 of this report, A&I intensified surveillance of the wheat market from October 2007 through March 2008.

<sup>12</sup> The two complaints concerning the liquidation of the May 2007 hard red spring wheat futures contract are discussed in greater detail in Section (V)(A)(4) on pages 20-24 of this report.

**volatile trading periods, and complete investigations in a timely manner, including conducting prompt interviews after a potential trading violation has been detected.**

- **Examine the underlying reasons for the large number of staff departures over the target period. This examination should include an analysis of the Exchange's budget to ensure that, among other things, competitive compensation and benefits are being offered to retain qualified investigators.**

## **V. MARKET SURVEILLANCE**

### **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 provide for the regular collection and evaluation of 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 problems that may arise from excessively large speculative positions, an exchange may need to establish speculative limits for some commodities. Rules establishing such limits may provide for hedge or other exemptions, and the limits may be set differently for each contract, delivery month, or period when in effect. Spot month limits should be adopted for markets based on commodities having limited deliverable supplies or where necessary to minimize a market's susceptibility to manipulation or price distortion.

Position limits may not be necessary for markets where the threat of manipulation is very low. For such contracts, such as financial instruments, an exchange may provide for position



accountability in lieu of position limits. An exchange should have an automated large trader reporting system that is used daily to enforce compliance with position limit rules.

#### **A. Daily Surveillance Activities**

The market surveillance program to monitor futures and options contracts trading on the Exchange primarily involves the daily recording and analyzing of statistical data combined with floor surveillance. As part of its daily surveillance activities, A&I manually records all surveillance data on the Daily Market Surveillance Log (“DMSL”) to monitor trading activity. The information on the DMSL is obtained from computer-generated reports and is used by A&I to identify possible price manipulation or price distortion and to increase the surveillance of expiring contracts. The daily surveillance focuses on the monitoring of cash and futures prices, spread and basis relationships, size and ownership of deliverable supply, and size of large trader positions relative to total open interest and deliverable supply.

##### **1. Volume and Open Interest**

A&I reviews several computer-generated reports to analyze potential market congestion. The Open Share Of Market-Regular Report and the Open Share Of Market-Segregated Report are reviewed by A&I staff to detect potential problems of concentration of positions with any one clearing member. These reports enable A&I staff to monitor gross positions for both house and customer accounts at each of the Exchange’s clearing members. On a daily basis, A&I posts the three largest long and short positions in the nearby month for each MGEX contract. This information is reviewed and recorded on the DMSL along with the percentage of open interest held by each clearing member.

A&I staff review all open contracts on a daily basis for any significant changes in open interest held by each member. Staff also consider external factors that may impact the market, such as economic news, embargoes, weather, and domestic and foreign markets crises. When significant changes in daily open interest are detected, staff conducts further analysis to determine the underlying causes for the change and the effect on the market.<sup>13</sup> During the target period, A&I detected that material decreases in open interest occurred during the contract month liquidation and delivery period for eight contract months.<sup>14</sup> For each of the contract months, A&I conducted a review of the trading activity, including a review of the long and short positions during the delivery process, monitored the deliveries, and held discussions with the clearing member firms to determine the intent of the position holders in relation to the delivery process. A&I determined the long position holders were liquidating their positions or were willing and able to take delivery while the short position holders were also liquidating their positions or held cash positions and intended to make delivery. A&I also determined the short position holders were sufficiently capitalized to meet MGEX margin requirements. A&I concluded the changes in open interest were primarily the result of routine trading activity. Consequently, no investigations were initiated as a result of the material decreases in open interest during the target period.

A&I's daily market surveillance activities also include reviewing the Volume and Open Interest By Clearing Member Report and Volume and Open Interest By Commodity Report. These reports detail all trades, transfers, deliveries and delivery intentions, cash exchanges for futures, and ending long and short positions on a gross basis for customer and house accounts for

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<sup>13</sup> An increase or decrease of 30 percent or more in the total open interest in any contract month, or a large switch from long to short or short to long, is considered to be a significant change. A&I did not detect any material changes in positions from long to short or short to long during the target period.

<sup>14</sup> December 2006, March 2007, May 2007, July 2007, September 2007, December 2007, March 2008, and May 2008.

each clearing member in each contract month. The information contained in these reports allows A&I to monitor changes in a clearing member's open position by analyzing the components of such changes.

## **2. Price Changes and Intermarket Relationships**

A&I records daily price ranges and settlement prices by contract month for the Minneapolis, Chicago, and Kansas City wheat markets. Settlement prices are also recorded by contract month for the electronically traded indexes. A&I calculates and records the change in settlement prices for each commodity future daily and compares the current settlement price with the previous day's settlement price. A&I also calculates the spread differential by comparing the current day's settlement in deferred months to the spot month settlement for each commodity. Similar monitoring of spreads for MGEX's indexes are conducted by comparing the NCI, NSI, HRSI, HRWI, and SRWI daily price ranges and settlement prices for those contracts with daily price ranges and settlement prices for CBOT corn and soybean futures, and the MGEX, KCBT and CBOT wheat futures respectively.

The review of price changes and spread relationships enable A&I staff to detect unusual price movements and aberrations in price relationships that could be indicative of an underlying problem in the market. If A&I detects substantial differences in price relationships, staff will investigate to ascertain the possible reasons for the discrepancies and evaluate the effect on the market, particularly in the nearby month.

Although A&I did not detect any significant price abnormalities during the target period, A&I intensified surveillance of the hard red spring wheat futures contract from October 2007 through March 2008 as a result of a sharp increase in the price of the wheat contract and unprecedented volatility. During the period of high volatility, the price of wheat in the cash market advanced much faster than the price of the futures contract. A&I determined that since

futures prices were capped and cash prices were not, the futures market no longer represented the true futures price and the futures/cash basis became temporarily distorted. MGEX worked closely with Division staff during this period to discuss wheat prices, trading volume, any large position holders in the market, and whether any margin calls had been received by the Exchange. A&I concluded the volatility was caused by a tight supply in the wheat market with stocks reaching a 30-year low as the available supply was unable to keep pace with the rising global demand. The Division believes the heightened surveillance of the wheat market was essential for the Exchange in order to fulfill its self-regulatory responsibilities. However, the Division also believes that the heightened surveillance should not interfere with the normal functioning of the Compliance Department, including the timely completion of substantive investigations, which is discussed below in the Trade Practice Surveillance section.<sup>15</sup>

### **3. Deliverable Supplies**

A&I monitors the availability of deliverable supplies to ensure the orderly liquidation of its hard red spring wheat contract, which is MGEX's only physically delivered contract, by reviewing the Stocks of Grain Report. The Stocks of Grain Report is prepared by A&I staff each Monday and is released the following Tuesday. This report is compiled by using data obtained by the Exchange from reports submitted by grain elevator operators. The report details the deliverable, non-deliverable (including ungraded), and Commodity Credit Corporation stocks of grain held in the Exchange-approved warehouses.<sup>16</sup> Additionally, the report compares figures from the previous week and for the same week in the previous year, which allows A&I to assess

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<sup>15</sup> Investigations 06-I-33 and 07-I-01 are discussed in detail in Section (VII)(C)(2) on pages 47-49 of this report.

<sup>16</sup> The Exchange-approved warehouses are the Minneapolis-St. Paul-Red Wing, Minnesota, Duluth, Minnesota, and Superior, Wisconsin switching districts, which are the delivery points for the hard red spring wheat contract.

any adverse changes.<sup>17</sup> The report is also used to determine if there is an adequate supply of grain with dispersed rather than concentrated ownership, and whether there are sufficient stocks of grain available for delivery. A&I assesses tight supplies and any concentrated ownership that can make the market susceptible to manipulation and monitors the availability of deliverable grain in relationship to open interest and concentration of positions. A&I contacts parties with outstanding warehouse receipts to confirm ownership; and regularly monitors railroad receipts, vessel shipments, and registered warehouse receipts to verify deliverable supply of hard red spring wheat. No significant discrepancies were identified during the target period.

#### **4. Heightened Surveillance of Expiring Contracts**

The heightened surveillance of expiring contracts typically begins when a futures contract becomes the nearby contract, or on the first day of the month prior to the month in which an option contract expires.<sup>18</sup> Enhanced options surveillance begins on the first day of the month the options contract expires.

As expiration approaches, A&I uses a number of computer-generated reports to monitor each clearing member's gross house (regular) and customer (segregated) account to ensure that futures contracts are liquidated in an orderly fashion and that options are properly exercised. A&I reviews the Open Share of Market and Volume and Open Interest by Clearing Member Reports to detect problems of potential concentration of positions among clearing members. The Open Share of Market report also allows A&I to monitor the largest three long and short position holders in the nearby futures contract. If a clearing member has 75 percent or more of the open

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<sup>17</sup> A&I monitors for any material changes in deliverable supply of 10 percent or more and contacts the grain elevator operator directly to verify the accuracy of the supply information and the reason for such a change.

<sup>18</sup> For example, heightened surveillance of the September 2007 hard red spring wheat futures contract began in the last week of July 2007 when the July 2007 contract expired. For the September 2007 options contract, heightened surveillance began on August 1, 2007, since the last day of trading and expiration day was August 24, 2007.

market share in an expiring futures contract, A&I will generally contact the clearing member to determine the intentions of the clearing member's customers and to ensure that customers with short positions are capable of making deliveries if they intend to maintain their positions into the delivery period.

A&I also reviews the Account Name Position Analysis Report ("ANPAR") to monitor positions and position holders.<sup>19</sup> This report is used by A&I as a risk management tool to identify position holders and their ability to make or take delivery. Further, A&I monitors open interest by comparing the open interest in expiring contracts to the weekly Stocks of Grain Report. Finally, A&I uses the ANPAR to determine if there is an adequate supply of grain with dispersed rather than concentrated ownership, and whether the concentrated ownership could make the market susceptible to manipulation.

Next, A&I monitors transfer trades for an expiring contract to ensure compliance with Exchange rules.<sup>20</sup> Prior to the offset prohibition period, A&I sends out an offset deadline reminder to clearing members and posts a copy of the reminder letter on the Exchange website. A&I monitors the trading activity as the delivery period approaches to ensure that clearing members and their customers are not offsetting positions for the purpose of avoiding delivery and impacting the open interest.

With respect to expiring options, A&I reviews the Delta Position Large Trader Report on a weekly basis and more frequently, when needed. The report lists all options traders holding

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<sup>19</sup> The ANPAR details the position holders by name, account number(s), gross positions, and the percentage of the market held for each contract and contract month.

<sup>20</sup> MGEX Rule 718.01 prohibits transfer trades that offset existing open positions during the delivery month. During the delivery month, and two business days prior to the first delivery day, transfer trades for the purpose of offsetting existing positions where no change in ownership is involved, is prohibited when the date of execution of the position being transferred is not the same as the transfer date. Such positions are required to be offset by trade activity or through the normal delivery process.

reportable options positions, the number of options positions (long or short, puts or calls), the expiration date, designation of commercial or noncommercial use, the FCM code, the CFTC reportable ID number, the delta (call or put), and the futures equivalent for calls or puts and long or short.<sup>21</sup> This report enables A&I to monitor the largest options holders for both house and customer accounts. A&I also reviews the Exercise Trade Register Report, which is generated if any options positions were exercised on the prior business day. This report details the clearing member, premium, quantity bought or sold, and the exercise dollar amount plus any differences. A&I reviews the report to ensure that options are properly exercised, particularly those on the last trading day. A Report of Exercises is also published daily by the clearinghouse and details each clearing member's options positions that were exercised. This report includes the opposite clearing member, the options contract exercised, the contract month, the quantity, and the strike price.

An Options Expiration Reminder is sent to each clearing member about a week prior to expiration reminding them of the Exchange requirements for clearing members concerning options expiration. Pursuant to MGEX rules, the clearinghouse automatically exercises in-the-money options in all MGEX option contracts, unless notice to cancel is given by the clearing member to the clearinghouse.<sup>22</sup> Each clearing member also receives the In-The-Money Report Summary, which provides details for each in-the-money option. The report summary includes the FCM code, the number of long and short options positions held, name of the house or customer account holding the option, and the settlement price of the expiring contract. A&I

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<sup>21</sup> An options delta represents the amount an option's premium will change for a given change in the underlying futures price. The futures equivalent of an options position is equal to the gross open interest times the delta.

<sup>22</sup> MGEX Rule 1404.01.

verifies that the clearinghouse received a written notification from the clearing member in the event that an in-the-money option is not automatically exercised.

A&I also works with the Commission's market surveillance staff and other government agencies prior to the expiring futures contract to share information, to monitor the delivery process, and to advise market participants of their responsibilities to ensure an orderly liquidation. Although all MGEX futures and options contracts were liquidated in an orderly manner during the target period, A&I received two complaints regarding the liquidation of the expiring 2007 May hard red spring wheat futures contract. As a result, two investigations were opened to address concerns regarding possible manipulation or abusive trading practices, including a squeeze or non-justified economic trading activity.<sup>23</sup> The complaints questioned whether a commercial with a large long position had the ability to take delivery, if there were adequate deliverable and alternate supplies available to MGEX market participants, and if artificial pricing existed due to the inverted prices for the May and July futures spreads.

The analysis conducted by A&I disclosed that the ownership of the available deliverable wheat stocks were dispersed among a large number of commercials and that their combined ownership represented only a small fraction of the overall stocks. Moreover, the U.S.D.A. Marketing Services representative indicated that there were alternative available supplies in the cash market. A&I also determined artificial prices did not exist and that inverted prices for the May and July futures spreads have historically been a component of the MGEX marketplace. Thus, there was no indication that the commercial had a sufficient dominant position to affect the May and July market price.

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<sup>23</sup> A squeeze is a market situation in which the lack of supply tends to force shorts to cover their positions by offset at higher prices.



In sum, A&I determined the evidence did not support any findings of rule violations during the liquidation of the expiring May 2007 hard red spring wheat futures contract or delivery period. All speculative traders (non-commercials) were able to reduce their positions to within the speculative spot month position limits two days prior to the first delivery date. Additionally, all commercials were confirmed with the Commission to hold position levels deemed to be economically justified and within their respective speculative position limit exemptions or were offset by warehouse receipts.

The Division's review of the investigation files opened to address the complaints revealed that the investigations were thorough, well-documented, and included appropriate analysis to determine if there was evidence to support the claims of potential manipulation.

## **B. Large Trader Reporting and Speculative Limit Enforcement**

During the target period, A&I received several large trader reports via encrypted email from the Commission's Chicago office each week.<sup>24</sup> These reports list the reportable MGEX accounts in futures and options and provide the account identification, expiration date, amount of futures or option positions (long or short, puts or calls), designation of commercial or noncommercial, strike price, clearing member code, and the name of the clearing member. A&I also receives the Delta Positions Large Trader Report on a weekly basis from the MGEX clearinghouse. This report is used by A&I to analyze large trader activity, monitor positions and position holders, and to determine the positions of hedgers versus speculators. A&I reviews all of these reports to monitor the activity of the largest traders in the market, identify and monitor

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<sup>24</sup> Currently, MGEX receives the following reports on a daily basis: MGEX Wheat Combined (futures and options with futures equivalency adjustment); MGEX Wheat Futures Positions – Omnibus Accounts; MGEX Wheat Futures Positions – No Omnibus Accounts; MGEX Options – Omnibus Accounts; and MGEX Options – No Omnibus Accounts.

accounts approaching spot month, single-month, or all-month speculative position limits, and to detect potential concentration of positions that could disrupt the market.

MGEX is a unique contract market since the majority of trades involve agribusiness firms that utilize the marketplace for hedging purposes. Thus, speculative positions are significantly less common at MGEX than at other exchanges. Nevertheless, A&I still monitors for compliance with speculative position limits.<sup>25</sup> If an account approaches the speculative limits, A&I will contact the clearing member to determine whether the clearing member has a hedge exemption on file for that account. If a speculative limit violation is detected, an investigation will be initiated and the matter may be referred to a disciplinary committee for further review and possible sanctions.

During the target period, one account exceeded the all-months limit in MGEX hard red spring wheat futures for a three-day period. The Exchange's investigation file indicated that the account holder did not intend to exceed the speculative limit. The account holder self-reported the violation to the Exchange and the Commission once it became aware of the violation. The account holder also reduced the positions immediately to comply with the speculative limit. The speculative limit violation was caused by a new managed account that had not been properly monitored. As a result of the violation, internal controls were implemented by the account holder to prevent future occurrences. The speculative limit violation also revealed that the parties involved did not fully understand the hedge and speculative position limit issues when combined with the positions held across multiple exchanges. Commission staff determined that the positions held by the account were not considered bona fide hedge positions and the account

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<sup>25</sup> The Exchange has adopted the federal speculative limits pursuant to Part 150 of the Commission regulations.

was reclassified as a non-commercial account. In view of the fact that the account holder had no prior speculative limit violations, the Exchange issued a staff warning letter.

Division staff reviewed the investigation file and found the file to be complete and included appropriate analysis to support the Exchange's findings.

### **C. Monitoring of Futures for Physicals and Exchange of Futures for Risk Transactions**

MGEX rules allow for two types of trades to be executed off the centralized market—transactions in futures made either in connection with Exchange of Futures for Physicals (“EFP”), for the purpose of establishing the price of cash commodities, and Exchange of Futures for Risk (“EFR”) transactions, which involve the exchange of futures contracts for or in connection with over-the-counter (“OTC”) derivative transactions.<sup>26</sup> The majority of ex-pit transactions are EFPs typically executed by commercials who have hedged their cash positions in the futures market. During the target period, a total of 333,411 EFPs and EFRs were executed, which accounted for approximately 12 percent of the Exchange's total futures volume. Trade data for EFP and EFR transactions are submitted to the clearinghouse and must include the clearing member, price, quantity, commodity, contract month, and the appropriate symbol identifying the trade as EFP or EFR.<sup>27</sup>

Pursuant to Exchange rules, the EFP and EFR transactions may be transacted at prices mutually agreed upon by the two parties to the bona fide transaction. If the price of an EFP cannot be mutually agreed upon by the date of shipment, the cash commodity buyer has the

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<sup>26</sup> The Exchange amended MGEX Rule 719.00 in 2004 to permit the exchange of futures in connection with OTC transactions in all futures contracts. Pursuant to MGEX Rule 2011.02, the last day that the NCI, NSI, or Wheat index futures contract may be exchanged for, or in connection with, an EFP or EFR transaction shall be the last business day of the contract month. The last day that a spring wheat futures contract may be exchanged for, or in connection with, an EFP or EFR transaction shall be the sixth business day following the last trading day of the contract month.

<sup>27</sup> MGEX Rule 719.00.

option to set the price within that day's trading range. An EFP or EFR executed during trading hours of the underlying futures contract must be submitted the same day for clearing. An EFP or EFR executed after the close of trading of the underlying futures contract must be submitted for clearing no later than the next business day.<sup>28</sup>

A&I reviews EFPs and EFRs during the course of their annual routine audit trail reviews of each clearing member. In this connection, A&I requests the underlying documents for all EFPs and EFRs transacted by the clearing member, such as confirmations, invoices, warehouse receipts, document of title, master swap agreement, and reviews them to verify that the transactions are bona fide and that the necessary cash transaction documentation exists. No EFP or EFR irregularities were found by A&I during its reviews. Division staff reviewed each of the audit trail reviews and also did not identify any irregularities with the EFP and EFR transactions that warranted further investigation. Division staff found that copies of the underlying documents are retained as part of the audit trail review files and investigation reports detail A&I's findings.

A&I also reviews EFPs and EFRs as part of its daily review of the Time Audit Report ("TAR"), the Exchange's trade register, for possible violations. A&I reviews EFPs or EFRs that have the same clearing firm and account numbers on both sides, involve unusually large quantities, or are priced outside the daily trading range. If irregularities are noted, A&I will contact the clearing member or account owner to request documentation verifying the bona fides of the EFP or EFR.

One EFP investigation was opened as a result of the TAR review during the target period. In Investigation 06-I-37, A&I requested the supporting documents for three EFP transactions

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<sup>28</sup> *Id.*

from a clearing firm to confirm that each transaction was a bona fide EFP. However, the firm was unable to produce any of the documents requested by A&I. As a result, A&I issued a staff warning letter to the firm for violating MGEX Rule 719.00. After the close of Investigation 06-I-37, A&I opened Investigation 07-I-27 to follow-up with the same clearing firm to ensure that it was complying with the Exchange's EFP recordkeeping requirements. In the follow-up investigation, A&I found that the firm complied with the Exchange recordkeeping rules and the case was closed without any disciplinary action.

#### **D. Conclusions and Recommendations**

MGEX maintains an adequate market surveillance program. A&I monitors cash and futures prices, spread and basis relationships, size and ownership of deliverable supply, and size of large trader positions relative to total open interest and deliverable supply. Surveillance of expiring contracts focuses on monitoring the largest long and short position holders, open interest, adequate grain supplies with dispersed rather than concentrated ownership, and the ability of short position holders to make delivery.

During the target period, A&I opened two investigations to address concerns regarding possible manipulation or abusive trading practices, including a squeeze or non-justified economic trading activity in the expiring May 2007 hard red spring wheat futures contract. After a comprehensive review, A&I found there was no evidence to support the claims. The Division's review of the investigation files disclosed that the investigations were well-documented and included a comprehensive analysis to support their findings.

A&I reviews several large trader reports to analyze large trader activity and monitor positions. These reports enable A&I to identify and monitor accounts approaching spot month, single-month, or all-month speculative limits, and to detect potential concentration of positions that could disrupt the market. At the end of the target period, one account exceeded the all-

months limit in MGEX hard red spring wheat futures for a three-day period. The account holder self-reported the violation to the Exchange and the Commission, and reduced the positions immediately to comply with the speculative limits.

The Exchange also has adequate procedures for monitoring reportable positions, enforcing speculative position limits, and reviewing EFP and EFR transactions to verify the legitimacy of such transactions.

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

## **VI. AUDIT TRAIL PROGRAM**

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

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

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

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

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

disposition. Further, an acceptable audit trail should include original source documents, transaction history, electronic analysis capability, and safe storage capability.

Original source documents include unalterable, sequentially identified records on which trade execution information is originally recorded, whether manually or electronically. A transaction history consists of an electronic history of each transaction, including all data that are input into the trade entry or matching system for the transaction to match and clear. These data should include the categories of participants for whom such trades are executed; timing and sequencing data adequate to reconstruct trading; and the identification of each account to which fills are allocated. Electronic analysis capability permits sorting and presenting data included in the transaction history so as to reconstruct trading and to identify possible trading violations, while safe storage capability provides for a method of storing the data included in the transaction history in a manner that protects the data from unauthorized alteration, accidental erasure, or other loss.

Commission Regulation 1.31 governs the manner in which an exchange is required to maintain trade-related records. The Regulation mandates that all records required to be kept under the Act or Commission regulations be maintained for five years and be readily accessible during the first two years. However, trading cards, documents on which trade information is originally recorded in writing, and order tickets, must be retained in hard copy for five years.

#### **A. Audit Trail for Electronic Trading**

As discussed above, all electronic trading at MGEX is conducted on Globex, the CME Group's electronic trading platform. CME Globex creates a comprehensive audit trail for electronic trades by automatically recording all messages entered into the system, and retaining them in a database for five years. The retained information includes all orders, order changes and order cancellations, all trades matched by the system, and the date and time of each message

and each matched trade, recorded to the nearest millisecond. No message, whether it consists of an order, order modification or cancellation, can be erased from the system.

Orders for MGEX contracts may be entered into Globex by MGEX members; by clearing members or the futures commission merchants (“FCMs”), introducing brokers (“IBs”); or other clients they guarantee; or by customers of such guaranteed FCMs or IBs using a CME-certified front-end system to transmit their own orders. Each person who enters an order into Globex must first log on to the system with a unique workstation user identification ID (“Tag 50 ID” or “ID”) that identifies the individual operator and is included in the data retained by the system with respect to every order.<sup>29</sup>

Tag 50 IDs are assigned to MGEX traders that access Globex by MGEX clearing members. Traders can access Globex from a variety of front-end applications that are available from the CME Group, FCMs, IBs, and independent software vendors (“ISVs”).<sup>30</sup> Traders can also connect to Globex through the Internet or through the network or data center of an FCM, IB, or ISV. Additionally, traders can connect to Globex using an electronic order routing system through iLink, the CME Group’s Globex Application Program Interface. Each MGEX clearing member assigns a unique ID to each person who enters orders into Globex through the iLink connection point.<sup>31</sup> All automated trading system (“ATS”) orders entered into Globex must be

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<sup>29</sup> The Tag 50 IDs are not case sensitive. For example, “ABC” and “abc” would be viewed as the same Tag 50 ID.

<sup>30</sup> The CME Group Globex Access Directory lists 13 ISVs that are certified for compliance with CME Globex and provide front-end trading access for trading of MGEX contracts.

<sup>31</sup> The CME Globex order entry interface iLink provides direct access to Globex markets and supports all of the enhanced functionality available on the platform. iLink is based on the FIX 4X protocol and supports customized trading systems for order entry, modification and cancellation, receipt of order confirmation, and fill information.



submitted with a Tag 50 that identifies the person who operates, administers and/or monitors the ATS.<sup>32</sup>

MGEX maintains a record of the workstation operator IDs issued by the clearing members that are registered with MGEX. The Exchange requires each clearing member to guarantee and assume financial responsibility for all orders it places and receives, and all contracts it clears through Globex.<sup>33</sup> MGEX rules also require that all written orders and any other original records pertaining to transactions effected through Globex to be retained for five years.<sup>34</sup>

Pursuant to MGEX rules, all members and nonmembers must sign a customer account agreement and establish an account with an Exchange clearing member before they are provided access to Globex.<sup>35</sup> Exchange rules require each participant to maintain confidentiality with respect to IDs and the participant is responsible for the security of their trading terminals that access Globex.<sup>36</sup> A&I manually reviews cleared trade activity to detect potential sharing of Tag 50 IDs. The Exchange also collaborates with clearing members to detect any potential user identification violations. No user identification violations were detected during the target period.

The audit trail for each electronic order includes the commodity, price, quantity, contract month, customer type indicator (“CTI”) code, order type (and order qualifier, stop price or trigger price, if applicable), order number, and account number. All of this information must be

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<sup>32</sup>An ATS is a system that automates the generation and routing of orders to Globex. The individual who administers and/or monitors the ATS is considered to be the ATS operator. This person in this role typically initiates or disables particular algorithms or strategies, adjusts the parameters of the automated program(s), or monitors the live trading of the ATS.

<sup>33</sup> MGEX Rule 1801.00.

<sup>34</sup> MGEX Rule 1811.00.

<sup>35</sup> *Id* at 33.

<sup>36</sup> MGEX Rule 1814.00.

entered into the system before Globex will accept an order. For modified or cancelled orders, audit trail data includes a record of the nature of the modification or cancellation. For executed orders, the data also includes complete fill information. A written order must be prepared for orders that cannot immediately be entered into the system and be entered when the orders become executable in the sequence in which the orders were received. All customer orders must be entered before a member or clearing member can enter orders for accounts in which they have a personal, financial, or proprietary interest.<sup>37</sup> All orders are matched according to an algorithm that gives priority to orders at the best price and orders with the same price based upon the time of entry into the system.<sup>38</sup>

A&I staff access MGEX trade activity through the CME Group Market Operations tools using FirmSoft, a web-based system that is accessible through CME Group Connect (via the Internet), to reconstruct audit trail data for electronic transactions. A&I staff use FirmSoft as part of their daily surveillance activities and the system has the capability to drill down and allow staff to go from a summary to a detailed analysis as needed. This system maintains current market data for executed trades for three trading days and A&I staff can customize searches of historical data that is stored on the Exchange's clearinghouse system (AS 400).

## **B. Enforcement of Electronic Audit Trail and Recordkeeping Requirements**

The Division found that, while the Exchange conducts regular reviews of compliance with its open outcry audit trail and recordkeeping requirements (discussed below), it does not conduct reviews to enforce compliance with its audit trail and recordkeeping requirements for electronic trading. A program of regular reviews of trader compliance with electronic audit trail

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<sup>37</sup> MGEX Rule 1807.00.

<sup>38</sup> MGEX Rules 1808.00 and 1809.00.

and recordkeeping requirements is an essential component of an adequate exchange compliance program and continuing exchange compliance with Core Principles 10 and 17. This is particularly true in light of the explosive industry-wide growth of electronic trading in recent years and the shift of nearly all of the Exchange's trading volume from open outcry to Globex that occurred after the target period. Therefore, the Exchange must move promptly to put such a program in place.

A satisfactory program for timely review of compliance with electronic audit trail and recordkeeping requirements would include examination by Exchange staff of randomly selected samples of front-end audit trail data for order routing systems. In such a review, investigators would verify for each order in the sample data that all required data fields are present and that the order's receipt and transmission into Globex are properly recorded. For example, Exchange staff would verify that the following data fields relating to order entry are present: transaction date, product, Exchange code, expiration month, quantity, order type, order qualifier, price, buy/sell indicator, stop/trigger price, order number, unique transaction number, account number, session ID, Tag 50 ID, host order number, trader order number, clearing member, type of action, action status code, CTI code, origin, and timestamp. For executed trades, the audit trail examination would verify that the execution time of the trade has been recorded along with the fill information. The samples would also be used to verify that all firms and individuals required to do so by Commission regulations and MGEX rules are retaining front-end electronic audit trail data for five years, and have it readily available for the most recent two years.<sup>39</sup> In addition, for all firms that issue the Tag 50 IDs, A&I would review the firm's procedures for assigning the IDs and maintaining current information regarding the registered user of each ID, and verify the registered user information for a random sample of the IDs issued by the firm.

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<sup>39</sup> See Commission Regulations §§ 1.31 and 1.35.

A satisfactory program would also include regular testing and verification of the use of the Tag 50 IDs, in order to ensure as far as practicable that all persons entering orders that reach the system are complying with identification requirements. For example, an exception report listing instances where a single ID issued to an individual has been logged in for all or most of an entire day or days, or an exception report which shows that a single ID was being used to trade multiple products, would trigger further investigation of whether the identifier in the report was being used improperly. Moreover, a satisfactory program would also verify whether firms that are issuing the Tag 50 IDs (that are unique to each individual) are not being shared by multiple parties at the firm. Since Tag 50 IDs are not case sensitive, A&I would review whether the firm is ensuring uniqueness by means other than solely modifying the letter between different Tag 50 IDs.

Finally, an appropriate electronic recordkeeping and audit trail review program would include assessment of compliance in this area by each clearing member. In particular, the program would use computerized reports to test the accuracy of the account numbers and CTI codes submitted by clearing members. Where CTI codes for given accounts are entered incorrectly, the firm would be required to explain and correct inaccurate CTI data. A&I staff would note any account number corrections made by the firm prior to trade clearing, and require the firm to explain unusual or frequent account number changes and correct any problems found. A&I staff would also assess whether all clearing members who are guarantors with respect to electronic trading system trading are maintaining electronic audit trail data in the manner required by Exchange rules and Commission regulations.

The program of electronic recordkeeping and audit trail reviews that the Exchange should put in place should enable the Exchange to identify firms and individuals that have not maintained generally high levels of compliance with all of the Exchange's electronic

recordkeeping and audit trail requirements. It should also enable the Exchange to take appropriate disciplinary action and conduct appropriate follow-up review wherever deficiencies in compliance are found.

Since the Exchange does not now have a program of electronic recordkeeping and audit trail reviews, the Division believes that development and execution of the necessary program may require the Exchange to increase the size of the A&I staff. The Exchange should move promptly to assess the staffing needed for such a program, and add sufficient staff to ensure its prompt development and effective use.

### **C. Audit Trail for Open Outcry Trading**

#### **1. Open Outcry Orders**

MGEX requires that members receiving customer orders for options trading to prepare a written record upon receipt in non-erasable ink and include the account identification, order number, and a timestamp to reflect the date and time to the nearest minute.<sup>40</sup> The orders are written on order tickets by clearing member staff. Typically, order tickets are walked into the trading pit and handed to a broker for execution. Upon execution, the broker records the essential trade data and returns it to the clearing member's desk on the trading floor where the order is timestamped again.

MGEX members record personal trades on double-sided pre-printed sequenced trading cards, with buys on one side and sells on the other.<sup>41</sup> Each trading card includes the member's name, clearing member's name, date, quantity, commodity, contract for future delivery or

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<sup>40</sup> MGEX Rule 756.00. During the target period and up until the closing of the trading floor for futures trading, members were required to follow MGEX rules applicable for open outcry orders.

<sup>41</sup> MGEX Rule 2062.00.

physical, delivery month or expiration date, price, transaction time to the nearest minute, opposite broker or trader, opposite clearing member, and for options, premium, strike price, and a put or call indicator.<sup>42</sup> Members are required to record purchases and sales in non-erasable ink, in exact chronological order of execution, on sequential lines of the trading card without skipping lines between trades, and crossed out any remaining lines on the trading card. Opening and closing periods are also required to be identified.

Trading cards are collected by clearing members within 15 minutes of each designated 30-minute interval, and clearing members submit the trade data to the MGEX clearinghouse through the Exchange's automated trade data entry and matching system ("TEMS"). TEMS enables clearing members to enter data directly from order tickets and trading cards into computer terminals that are located typically in the clearing firm's booth on the trading floor. Transactions are required to be entered into TEMS within 45 minutes of the conclusion of each 30-minute interval.<sup>43</sup>

## **2. Trade Timing for Open Outcry Trades**

MGEX requires both the buyer and seller of each options transaction to manually record the time of each trade to the nearest minute on his or her trading card. The Exchange enforces this requirement by reviewing the Time Audit Report on a daily basis. The TAR contains time and sales data, thereby incorporating a comparison of the matched trades to the time and sales data. The purpose of this comparison is to determine whether a match could be made between

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<sup>42</sup> Members were required to record indicators for the following transactions: (C) cash exchange, (T) office transfer, (S) spread, and (D) delivery.

<sup>43</sup> MGEX Resolution 2101.C. provides that clearing members have until 3:00 p.m. to resolve any unmatched trades. Any unresolved transactions may be suspended pending possible resolution the following business day as an "as of" trade. "As of" trades can be carried no longer than one business day.

the trades reported by members on their trading records and prices and times of execution reported in the time and sales data.

The TAR identifies five types of timing errors that may be indicative of a trade timing violation. Any discrepancies in excess of one minute automatically generate an error code on the TAR trade exception report. The five error codes are: Bought Side-No Trade (“B-NT”),<sup>44</sup> Sold Side-No Trade (“SNT”),<sup>45</sup> Time Out of Limits (“TOL”),<sup>46</sup> Bought Side-Untimed Trade (“B-UT”),<sup>47</sup> and Sold Side-Untimed Trade (“SUT”).<sup>48</sup>

In addition to reviewing the TAR, A&I assesses the accuracy of each member’s manually recorded execution times by reviewing the Broker Error Type Report (“BETR”). The BETR is a compilation of error codes derived from the TAR and summarizes the number of errors by type for each member on a daily or monthly basis along with a cumulative total for each member. If A&I finds that a member’s trade timing deficiency level exceeded the daily or monthly thresholds,<sup>49</sup> A&I examines the underlying trade documents as well as the time and sales data to determine the “audited” error threshold. The “audited” rate includes adjustments based on the cause of timing errors, such as keypunch errors by clearing member personnel, a member

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<sup>44</sup> The TAR compares the time recorded by the buyer to the time and sales data. If no trade is indicated on the time and sales at the time recorded by the buyer, or within one minute preceding or one minute following that time, the trade is assigned a code of B-NT.

<sup>45</sup> The computer program followed the same procedure as the B-NT code, but compares the seller’s recorded time to the prices recorded on the time and sales.

<sup>46</sup> The TOL error code is generated if the times recorded by both the buyer and the seller are marked as accurate by the system, but there is more than one minute between the two times.

<sup>47</sup> The B-UT error code is assigned to the buyer if a trade clears without a transaction time on the buy side.

<sup>48</sup> The S-UT error code is generated and assigned to the seller if a trade cleared without a transaction time on the sell side.

<sup>49</sup> On a daily basis, a member with a 20 percent total timing error rate with at least 20 timing errors may be investigated unless the member is already the subject of an open investigation. On a monthly basis, a member with a 10 percent total timing error rate with at least 20 timing errors may be investigated. In addition, all trades cleared without trade times are subject to investigation.

recording an incorrect time of execution on the original source document, or a member's illegible handwriting. Timing errors can also be attributed to a member failing to promptly report the trade to the MGEX market observer ("ring reporter") or not reporting the trade at all, as well as the market observer not recording the trade promptly or never recording the trade.<sup>50</sup> If the audited error rate is found to be under ten percent, the member receives a reminder letter. If the audited error rate is found to be more than ten percent, the member receives a staff warning letter. If members are found to be repeatedly negligent in recording accurate times of execution, or fails to report transactions to the market observers, they may be subject to disciplinary action by the Futures Trading Conduct Committee ("FTCC").

The Exchange closed seven investigations based on timing error rate thresholds during the target period. As a result, the Exchange issued three staff reminder letters, one staff warning letter, two investigations resulted in no action, and one investigation was referred to the FTCC. The limited number of investigations opened can be attributed to a high rate of compliance by MGEX members. In this regard, the Exchange's monthly timing accuracy rate for all hard red spring wheat futures and options contracts combined during the target was approximately 95 percent.

#### **D. Floor Order Tickets and Trading Cards**

MGEX conducted an annual audit trail review of each clearing member during the target period to evaluate compliance with the Exchange's order ticket and recordkeeping requirements. For each review, A&I randomly selected one trading day and examined all of the clearing member's trading cards and order tickets for the review.

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<sup>50</sup> MGEX Rule 725.01. Each party to a futures or options transaction made competitively in the pit must promptly notify the market observer(s) of the price at which the trade has been executed.



During the target period, A&I opened 23 audit trail reviews.<sup>51</sup> Twenty-two reviews were also closed during the target period, including five opened prior to the target period. At the end of the target period, seven audit trail reviews remained open.

In the course of the 22 closed audit trail reviews, A&I examined a total of 511 order tickets prepared by the fourteen clearing firms and 250 trading cards prepared by 42 floor members whose trades were cleared by those firms on the dates selected for the reviews. As a result of these reviews, the Exchange issued four staff warning letters and 59 staff reminder letters for recordkeeping, submission, or timestamping deficiencies. A&I found a high rate of compliance with the Exchange's recordkeeping requirements in the 22 audit trail reviews. All order tickets examined by A&I contained account identification, and 99 percent included both entry and exit timestamps. With respect to personal trading cards, all trading cards were written in non-erasable ink and 97 percent of the cards had transactions recorded in sequence, no skipped lines, and included the date, commodity, price, quantity, and put or call indicator for option trades. Additionally, the opening and closing periods were properly identified in 98 percent of the trading cards. Finally, 96 percent of all cards were collected by the clearing firm within 15 minutes of each 30-minute trading interval, 95 percent of the trading cards reviewed were preprinted with members' identification and trading card sequence number, and had unused lines properly marked through.

The Division reviewed the audit trail reviews closed during the target period and found that they were thorough and well-documented. Each file included a summary of the

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<sup>51</sup> There were 17 clearing firms at MGEX during the target period. A&I conducted audit trail reviews of eight clearing firms twice during the target period. Audit trail reviews were not conducted for three of the 17 firms during the target period. Two of these firms did not clear any open outcry trades during the target period and one firm did not begin clearing MGEX transactions until February 2008, and MGEX initiated a review of this firm after the close of the target period.

investigation, copies of original source documents, spreadsheets and other documents detailing the findings of each transaction reviewed, an investigation report, and copies of disciplinary letters (where applicable).

### **E. Safe Storage Capability**

Commission Regulation 1.31 governs the manner in which an exchange is required to maintain trade-related records. The regulation mandates that all records required to be kept under the Act or Commission regulations be maintained for five years and be readily accessible during the first two years. Acceptable methods of record retention include electronic storage media for both the two and five year periods.

MGEX can access complete audit trail data for both electronic and open outcry trading on the AS 400, the Exchange's clearinghouse system, which is located at the Exchange's headquarters.<sup>52</sup> The Exchange also has a back-up server, located on a separate floor of the Exchange building, which stores this data. Additionally, the Exchange stores the audit trail electronically at an off-site facility. The Exchange also copies the audit trail data onto tape back-up cartridges that are retained with clearinghouse staff each evening. The data on the back-up and off-site servers, as well as and the tape cartridges, are retained for at least two years. Furthermore, MGEX creates daily back-ups of all audit trail data on the Exchange's general file server, which is housed at MGEX's data center in the Exchange building. As an additional safeguard, the data from the general file server is sent off-site daily over the Internet via an encrypted application to a Minneapolis-based vendor contracted by the Exchange. The data transmitted to the vendor is simultaneously replicated to multiple sites in the Minneapolis

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<sup>52</sup> Copies of each day's TAR, time and sales, and TEMS clearing data are stored on the AS 400 production server, a back-up server located at the Exchange's headquarters, and a back-up server at an off-site facility.

suburbs and to a data hosting center in New Jersey. Archived data for electronic and open outcry trading is stored for five years at off-site servers. MGEX also retains five years' worth of trade data in hard copy form, stored in a vault in the Exchange building.<sup>53</sup> Finally, MGEX's audit trail data for open outcry and electronic trading is transmitted over the Exchange's local area network, wide area network, or the Internet to a disaster recovery site that also serves as a data operations center for the Exchange, and is located a significant distance from the Exchange's headquarters.

## **F. Conclusions and Recommendations**

The Division found that MGEX maintains an adequate audit trail program for open outcry trading, which records trade data in a manner that enables A&I to identify customer and market abuses and provide evidence of rule violations. The Exchange conducts an annual audit trail review of each clearing member to evaluate compliance with relevant recordkeeping and submission requirements. Members and clearing firms demonstrated a high rate of compliance with Exchange recordkeeping requirements during the audit trail reviews. The Division found that the audit trail reviews were thorough and well-documented.

For electronic trading, MGEX maintains a complete electronic record of all orders entered and all transactions executed, including the terms and time of entry for each order, all order modifications, and all matched trades. This record enables MGEX to reconstruct electronic trading efficiently and effectively. However, the Exchange's audit trail program does not include a programmatic review of the electronic audit and recordkeeping rules that is comparable in rigor and scope to its review program for open outcry trades.

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<sup>53</sup> Trade data in hard copy form is maintained by A&I at the Exchange's headquarters for approximately two months before it is transferred to the vault.

The Division found that MGEX has adequate safe storage capability for its trade data. The Exchange retains five years' worth of open outcry trade data in both computerized and hard copy form, and five years' worth of electronic trading data. Both open outcry and electronic trade data are also stored off-site on an AS 400 server and back-up tape cartridges.

Based on the foregoing, the Division recommends that:

- **The Exchange augment its audit trail compliance program for electronic trading to include a programmatic review of electronic audit and recordkeeping rules that is comparable in rigor and scope to its review program for open outcry trades.**

## **VII. TRADE PRACTICE SURVEILLANCE PROGRAM**

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

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

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

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

Pursuant to Appendix B to Part 38 of the Commission's regulations, a contract market's trade practice surveillance program should have the arrangements, resources, and authority necessary to perform effective rule enforcement. The arrangements and resources attendant to the program should facilitate the direct supervision of the contract market, including analysis of relevant data.

An acceptable trade practice surveillance program should have systems that maintain all data reflecting the details of each transaction executed on the contract month. In this regard, the program should include routine electronic analysis of these data to detect potential trading violations. The program also should provide for appropriate and thorough investigation of all potential trading violations brought to the contract market's attention, including member and

Commission referrals and customer complaints. In addition, the program should have the authority to discipline, suspend, or terminate the activities of members or market participants pursuant to clear and fair standards.

### **A. Automated Surveillance System**

The TAR and BETR serve together as the Exchange's automated trade practice surveillance system for identification of possible trade practice violations for open outcry and electronic trading. The TAR combines the details of all futures and options trades in chronological order with Exchange time and sales data. The options trades are listed separately from trades executed on the electronic platform.<sup>54</sup> The TAR generates error codes based on preset parameters that identify possible substantive trade practice abuses, such as wash trading or trading ahead.<sup>55</sup> The system also identifies cross trades, which are referred to as "ring trades" at the Exchange.<sup>56</sup> On a daily basis, A&I staff reviews the error codes generated by the TAR as well as the BETR to look for patterns of exceptions concerning individual brokers.<sup>57</sup>

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<sup>54</sup> The same was true of futures transactions when they traded on the floor.

<sup>55</sup> The TAR generates error codes identifying potential instances of the following along with the applicable error codes: accommodation trading ("ACC"), buyer or seller trading ahead ("BTA" or "STA"), invalid CTI ("CTI"), invalid ring trade ("IRG"), invalid spread ("ISP"), money pass ("MPS"), no summary record ("NSR"), price above daily high ("PAH"), price below daily low ("PBL"), post settlement trade error ("PTE"), and wash trading ("WSH"). During the target period, the Exchange implemented several new error codes on the TAR to enhance surveillance of the side-by-side trading environment. The new error codes are cross buyer or cross seller trade ahead ("CBA" and "CSA"), cross accommodation trading ("CAC"), cross money pass through ("CMP"), and cross wash ("CWS"). The purpose of the new error codes is to enable A&I staff investigators to compare trading activity on the open outcry platform to the trading activity on the electronic platform to detect potential trade practice violations across the two platforms. These error codes are now limited to options contracts since all futures trade only on Globex.

<sup>56</sup> A&I verifies ring trades by reviewing the written record that is completed and signed by the market observer at the time the trade was executed in the trading pit.

<sup>57</sup> Each staff investigator is assigned to conduct a daily review of the TAR in conjunction with preparing the Daily Market Surveillance Log ("DMSL"), which is discussed in Section (V)(A) on page 16 of this report. This assignment is rotated on an every-other-day basis between staff investigators.

## **B. Floor Surveillance**

Staff investigators conduct floor surveillance during the openings and closings of all options contracts and at three randomly selected times throughout the trading session.<sup>58</sup> One staff investigator is present on the trading floor five minutes prior to the open and remains on the trading floor five to 15 minutes after the open. If trading opens on a volatile note, the staff investigator remains on the trading floor to monitor trading until volume activity subsides. At the close, a staff investigator is present on the trading floor approximately 15 minutes prior to the close and remains on the trading floor several minutes after the post-settlement session. When a staff investigator conducts floor surveillance, the investigator monitors, among other things, trades executed prior to the opening or after the close, disclosure of orders, illegally executed ring (cross) trades, noncompetitive trading, improper bidding or offering, and transactions not executed by open outcry. Staff investigators also take into consideration account rules governing trading activities, such as the execution of ring trades, simultaneous purchases and sales, and spread transactions.

A&I documents floor surveillance in two logs, the “pit population log” and “price surveillance log.” Staff investigators complete a pit population log when floor surveillance is conducted during the opening and closing sessions. The pit population log lists the date and time period floor surveillance was conducted, the number of brokers in the various pits during several one minute intervals, observations of trades executed between brokers, and comments about current market activity. The pit population log can be used to verify who was on the floor at the time of a particular trade.<sup>59</sup>

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<sup>58</sup> The Exchange conducted floor surveillance for all futures trading during the target period and up until the closing of the trading floor.

<sup>59</sup> During the target period, nine non-substantive investigations were opened based on floor observations by A&I or trading floor staff. Investigation 08-I-06 resulted in a \$125 fine against a floor broker for consuming food and a

The price surveillance log is generated by the Exchange's primary market data vendor to provide a snapshot of real-time quotes for the MGEX, KCBT and CBOT wheat, corn, and soybean markets. The price surveillance log is compiled for the opening and closing markets and randomly throughout the trading session depending on market conditions.

## **C. Trade Practice Investigations**

### **1. Initiation of Inquiries and Investigations**

Pursuant to the guidelines in the Exchange's Compliance Manual, an inquiry is initiated if ten percent of an individual broker's trades on any trading day, or five percent of a broker's trades during any month, appear on exception reports regarding potential substantive trade practice abuses. A&I opens a formal investigation into instances of potential trade practice violations whenever an initial staff review of exception reports, an investigator's analysis of trade data, a floor surveillance observation, or an inquiry indicates that an investigation was warranted.<sup>60</sup> Investigations are also opened for all customer or member complaints and all referrals by the Commission.

As part of every investigation, A&I reviews all trades by the members involved which were executed during the review period selected for the investigation. Copies of all trade documents along with the TAR are maintained in the investigation file.<sup>61</sup> Notations regarding document requests and a summary of the analysis are documented in close proximity to the

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beverage in the trading pit in violation of Exchange rules. Investigation 08-I-13 resulted in a \$25 fine against a floor broker for wearing blue jeans in the trading pit in violation of Exchange rules. Investigations 08-I-01, 08-I-03, 08-I-05, 08-I-08, 08-I-12, 08-I-16, and 08-I-19 resulted in letters of reprimand for decorum or attire violations.

<sup>60</sup> Inquiries, which are less formal than investigations, are opened whenever A&I staff encounters an anomaly which needs further attention and examination. A&I opens a formal investigation whenever it discovers possible violations of a serious nature or whenever an inquiry indicates a possible violation of Exchange rules which needs to be pursued further.

<sup>61</sup> Prior to January 2007, copies of irrelevant trade documents were discarded after the review was completed.

flagged trades on the TAR. At the conclusion of an investigation, A&I prepares an investigation report detailing the steps taken during the investigation and the reasons for A&I's determination concerning what action, if any, should be taken.

## **2. Adequacy of Investigations**

During the target period, the Exchange closed 15 trade practice investigations, including four opened prior to the target period and 11 opened during the target period. The Division thoroughly reviewed all of the 15 closed investigations and found that they were well-documented and that the findings were supported by appropriate analyses. Each of the files included an A&I file cover sheet that provided a brief summary of events and an investigation checklist.<sup>62</sup> The files also included copies of the TAR, time and sales data, copies of trade documents, copies of computer-generated reports, financial statement analysis, summary of trading activity, work papers, interview notices, summary of interviews, copies of relevant correspondence including emails, past disciplinary history, and copies of disciplinary letters. At the close of each investigation, A&I staff prepared an investigation report. The reports detailed the source of the investigation, analysis, findings of facts discovered during the investigations, conclusions, and recommendation(s).

Of the 15 closed investigations, eight were generated based upon reviews of the TAR, three resulted from floor surveillance by A&I staff, two resulted from customer complaints, and two resulted from a CTI code review.<sup>63</sup> Three of the 15 closed investigations involved potential

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<sup>62</sup> The purpose of the A&I cover sheet is to summarize the various documents in the file and to inform the reader of the status of an investigation. The A&I cover sheet includes, among other things, the date the investigation was opened and closed, the alleged violations cited, the member and/or member firm under investigation, the source of the investigation, requests for documents, issuance of interview notices, violations cited, referral to a disciplinary committee, and any final action taken. Similarly, the purpose of the investigation checklist is to assist in the accurate, thorough, and timely completion of an investigation.

<sup>63</sup> The eight investigations generated based upon reviews of the TAR included seven for trade timing error rates and one for a cross sell trade ahead ("CSA").



trade practice violations of a substantive nature. The first trade practice investigation of a substantive nature, Investigation 06-I-33, was opened to determine whether a floor broker executed trades during the closing period with the intent of affecting the settlement price, either up or down, for some personal benefit. A&I concluded that the evidence did not support a finding of a rule violation and the case was closed without any further action.<sup>64</sup> The second investigation involving possible substantive trade practice violations, Investigation 07-I-01, included a floor broker and clearing member that received staff warning letters for failing to ensure a customer order was executed openly and competitively in the pit by open outcry.<sup>65</sup> Last, Investigation 08-I-15 involved a member that compromised the integrity of the market by reporting bids that were not bona fide. This case was referred to the Business Conduct Committee (“BCC”) for disciplinary action.<sup>66</sup>

Although the Division found that all of MGEX’s closed investigations were thorough, it identified two issues of concern. First, the Division found that the interviews conducted by A&I

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<sup>64</sup> A&I staff conducted a review of the closing range of the July 2007 hard red spring wheat futures contract that settled on October 12, 2006. The hard red spring wheat futures contract settled up 15 cents while the other MGEX hard red spring wheat futures contract month settlements included a settlement range of up 4 ½ cents to down 13 ½ cents for the day. A&I staff observed a floor broker execute a July 2007 contract opposite another floor broker that appeared to be 10 cents higher than the last reported bid prior to the close. A&I concluded that this trade occurred during an upward trend in fast market conditions during the last minute of trading.

<sup>65</sup> A&I staff conducted a review of the December 29, 2007, and January 3, 2008, closing sessions for the March 2008 hard red spring wheat futures contract. A&I staff observed that the December 29 settlement price of \$5.05 ¾ was out of sync with the settlement prices for the other hard red spring wheat futures contracts. Additionally, A&I observed floor broker “A” execute trades for the personal account of floor broker “B” during the closing sessions of both trading days that appeared to be unusual. Staff was concerned that floor broker “A” executed the trades with the intent of affecting the settlement prices to benefit floor broker “B.” A&I determined floor broker “A” did not violate Exchange rules of bidding or offering above or below the market price in an attempt to manipulate the market on December 29. With respect to the closing session on January 3, A&I staff observed floor broker “A” execute a market order to sell one contract during the closing period on behalf of floor broker “B.” Since this was the only contract that traded during the closing period, the hard red spring wheat futures contract settled up 19 ¼ cents from the December 29 closing price. A&I determined that there were no apparent bids reported to, observed, or inserted by the market observer during the minutes immediately following the receipt of the market order up to the execution of the market order by floor broker “A” approximately 12 minutes later. Although floor broker “B” did not suffer or any harm or complain of damages, the Exchange issued staff warning letters to floor broker “A” and the clearing member for violating Commission Regulation 1.38.

<sup>66</sup> Investigation 08-I-15 is discussed in greater detail in the Section (VIII)(C) on pages 53-55 of this report.

of the subject brokers in Investigation 06-I-33 were not conducted in a timely manner. The interviews were conducted more than four months after the trades in question were detected. As a result, the interviews were ineffective since the brokers could not recall the precise circumstances under which the trades in question took place. The Division believes lengthy delays often prove detrimental to the quality of the investigation and to a compliance department's case because over time witnesses tend to forget or cannot recall crucial information concerning a trading event.

Second, the Division is concerned that Investigations 06-I-33 and 07-I-01 were open for more than one year. The staff investigator assigned to both investigations left the Exchange prior to completing the investigations. During the Division's rule enforcement interview, the Director of Compliance indicated that the delay in completing Investigation 06-I-33 was caused by "other departmental priorities" and staff turnover required the Director to assume the responsibilities associated with completing this investigation. The Division believes that A&I staff turnover, the heightened surveillance of the wheat market during a period of high volatility, and the need to address two complaints concerning the liquidation of the May 2007 hard red spring wheat futures contract contributed to the delays in completing the investigations. The Division recognizes that delays in completing investigations in a timely manner can occur from time to time due to unanticipated circumstances, such as staff turnover and special projects. However, chronic staff turnover and the assignment of investigators to special projects should not interfere with the normal functioning of an exchange's compliance department. The Division believes that lengthy delays in completing investigations have an adverse effect on the effectiveness of an exchange's rule enforcement program because, among other things, prompt investigation and disciplinary action are necessary to discourage further violations of exchange rules.

## D. Conclusions and Recommendations

The Division found that MGEX generally maintains an adequate trade practice surveillance program. Staff investigators reviewed the TAR and the BETR to identify possible trade practice violations in open outcry and electronic trading. A&I conducted daily floor surveillance of open outcry trading during the opening and closing of all contracts and at randomly selected times throughout the trading session and continues to conduct appropriate floor trading of options trading.

A&I closed 15 investigations during the target period, three of which included potential substantive trading violations. The Division found that the 15 closed investigations were thorough, well-documented, and the findings were supported by appropriate analyses.

Interviews were conducted in both trade practice investigations to obtain information critical to the trading events. However, the Division found that the interviews of the targets in one investigation were not conducted in a timely manner. The Division believes that the interviews were ineffective since the brokers could not recall the details surrounding the trades in question. Furthermore, the Division believes that timely interviews are essential to obtaining information necessary to reconstruct the events surrounding possible trade practice violations.

The Division also found that two investigations remained open for more than one year. Although both investigations required extensive analysis, the Division found that the delays in closing these investigations were caused by staff turnover, A&I's limited resources, and other departmental priorities.

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

- **Take appropriate measures, including hiring additional staff, to ensure that interviews are conducted promptly after a potential trading violation is identified and that investigations are conducted in a timely manner.**

## **VIII. DISCIPLINARY PROGRAM**

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

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

Core principle 2 requires that exchanges take effective disciplinary action whenever a rule violation is suspected. Disciplinary actions must be prompt and conducted pursuant to clear and fair standards. Exchanges must have the authority to discipline, suspend, or terminate the activities of members or market participants found to have committed rule violations.

### **A. Disciplinary Committees and Procedures**

The Exchange has two disciplinary committees, the Futures Trading Conduct Committee and the Business Conduct Committee. The FTCC has jurisdiction over matters concerning futures and option trading, including consideration of possible trading violations, while the BCC has jurisdiction over all other potential violations, such as registration issues, clearinghouse matters, position limits and margins. The disciplinary committees do not have a regular meeting schedule, but meet on an as-needed basis when called to do so by the Chief Executive Officer and President after he approves an A&I recommendation that a matter be brought before one of the committees.

The FTCC consists of seven members, including the Chairperson of the Board of Directors (“Board”), the Exchange President, and five members of the Exchange appointed by the Chairperson. The BCC is comprised of the Chairperson of the Board, the Chairperson of the Clearinghouse Committee, the Exchange President and four members appointed by the Chairperson of the Board. Pursuant to Exchange rules, the FTCC and BCC must include at least one committee member who is not a member of the Exchange in all cases where the subject of a proceeding is a member of the Board, the BCC, or the FTCC, or where the allegations involve

either price manipulation or financial harm to a nonmember. A BCC or FTCC member may not participate as a member of the Committee if the member has a financial, personal, or prejudicial interest or concern in the matter before the Committee. The Committees determine whether any of their members have such an interest or concern.

Upon receiving an investigation report from A&I, the FTCC or BCC may issue a notice of charges, issue a warning or reminder letter, direct A&I to gather additional information, or determine that no reasonable basis exists for taking disciplinary action. A notice of charges sets forth the alleged violation and the exchange rules believed to have been violated, and advises the respondent of his right to a hearing. The respondent has 10 days to file a written response and to request a hearing. Failure to do so is deemed to be an admission of the charges and a waiver of the right to a hearing. The respondent has the opportunity to be represented by counsel, call witnesses, and offer evidence at a hearing. At the discretion of the respective disciplinary committee, A&I may be given authority to negotiate and/or accept a settlement with the respondent in satisfaction of the notice of charges. Both disciplinary committees have the authority to hold hearings on contested charges and function as a “Hearing Committee” in such cases.

Following a hearing, the disciplinary committee may take disciplinary action, or close the case based upon a finding that no violation occurred. If the committee finds that there has been a violation, it may issue a letter of reprimand, a monetary fine, a suspension from membership, or recommendation to the Board for expulsion. Any suspension of 30 days or more, any fine of \$10,000 or more, and any expulsion, is subject to Board approval. A respondent can appeal the findings or penalty imposed by a disciplinary committee to the Board. However, appeals are heard at the discretion of the Board. If the Board takes an appeal, it is based on the record of the

hearing. If a respondent does not file an appeal, the penalty becomes effective on the date set forth in the disciplinary committee's decision.

A&I can also issue staff reminder letters and staff warning letters for infractions of recordkeeping, decorum, or other similar rules, without the matter being referred to a disciplinary committee. All staff reminder letters and warning letters are recorded in investigation files, and become part of the recipients' disciplinary histories.

### **B. Reminder and Warning Letters**

A&I issued a total of 16 warning letters and 62 reminder letters during the target period. One clearing member received five staff warning letters and two staff reminder letters during the target period. Three of the five staff warning letters and one of the two reminder letters were issued in an 11-month period for filing inaccurate position reports with the clearinghouse.<sup>67</sup> Additionally, the member had already been sanctioned \$300 in 2005 for the same violation. The Division believes that absent mitigating circumstances, the Exchange should issue no more than one reminder and one warning letter to a member in a rolling 12-month period, and monetary sanctions should follow thereafter. The practice of issuing a series of warning or reminder letters is not an effective deterrent or incentive for the members to modify their behavior.

### **C. Adequacy of Sanctions Imposed**

During the target period, A&I referred one investigation to the FTCC that involved a member failing to report trade activity on a trading card.<sup>68</sup> A&I also referred five additional investigations involving recordkeeping-type violations and one investigation involving

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<sup>67</sup> See MGEX Rule 2100.00.

<sup>68</sup> Investigation 07-I-20 resulted in a \$750 fine against a member for violating MGEX Rules 725.01 and 2062.00.

substantive violations to the BCC.<sup>69</sup> Notice of charges were issued in all of the cases and all of the cases were concluded by settlement agreements.

The recordkeeping-type violations included two cases of inaccurate reports to the clearinghouse and offsetting positions without the benefit of trade activity; one was limited to inaccurate reports to the clearinghouse; one was limited to offsetting positions without the benefit of trade activity; and one included a failure to submit a long position report to the clearinghouse. The investigation involving substantive violations concerned a member who compromised market integrity by reporting bids in the hard red spring wheat futures market that were not bona fide.<sup>70</sup>

During the target period (and including a time very shortly thereafter) MGEX assessed fines totaling \$12,750 and imposed a 10-day suspension.<sup>71</sup> The Division notes that the Exchange issued a meaningful penalty that included a \$10,000 fine and a 10-day suspension in connection with Investigation 08-I-15, the case that involved substantive trading violations. The Exchange also imposed two \$250 fines, three \$500 fines, and one \$750 fine in the six recordkeeping cases. The Division seriously questions whether any of the recordkeeping fines were of sufficient magnitude to have any deterrent value to ensure that these firms do not again violate the same rules. The Division believes more substantial sanctions are necessary to discourage future rule violations.

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<sup>69</sup>The Division notes that two investigations, Investigations 06-I-19 and 06-I-20, were referred to the BCC four days prior to the start of the target period. Given the limited number of investigations referred to the disciplinary committees during the target period and because both of these cases settled during the target period, the Division included these investigations in its review of MGEX's disciplinary program.

<sup>70</sup> Investigation 08-I-15 was initiated after A&I observed the member bid-up the May 2008 hard red spring wheat contract on May 14, 2008, the last day to trade the May contract, from \$13.00 to \$23.00 in \$1.00 increments. Since there was no activity in the May contract on that day, the contract settled at \$23.00, which was \$10.50 more than the settlement price on the previous day. A&I determined the bids offered by the member were not genuine.

<sup>71</sup> Investigation 08-I-15 closed on June 25, 2008, and was brought before the BCC two days after the close of the target period on July 2, 2008, and was included in the Division's review due to the significance of the violations.

The Division is further concerned about the adequacy of the sanctions imposed in two of the recordkeeping cases because they involved repeat offenders. First, in Investigation 06-I-20, a clearing member was fined \$500 fine for offsetting settlement month positions without the benefit of trade activity.<sup>72</sup> A review of the member's disciplinary history includes fines ranging from \$500 to \$1250 in three separate cases from 2001 to 2005 for violating the same or similar offset rules. While all three of those cases included an additional violation for failing to file an accurate position report with the clearinghouse, the Division believes a larger sanction was warranted in this case given the member's history of violating the offset rules. The BCC only considered the disciplinary case from 2005 that resulted in a \$500 fine as relevant in determining an appropriate sanction amount because the BCC only reviews disciplinary cases from the previous two years.

Second, in Investigation 07-I-03, a clearing member was fined \$250 fine for failing to submit an accurate position report to the clearinghouse and for offsetting delivery month positions without the benefit of trade activity.<sup>73</sup> The member also was fined \$250 in 2005 for filing an inaccurate position report to the clearinghouse. Thus, the member received the same fine in 2005 as the case from the target period even though the target period case also included the offset violation. The Division's review of the Exchange's investigation report indicates that the BCC did not consider the clearing member's fine from the 2005 disciplinary case. The Division believes that the BCC should review and take into account a member's complete disciplinary history in determining appropriate sanctions.

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<sup>72</sup> MGEX Rule 7312.00 provides that transfer trades for the purpose of offsetting existing futures positions, where no change in ownership is involved, are prohibited two business days prior to the settlement month and during the settlement month when the date of execution or exercise of the position being transferred is not the same as the transfer date. Such positions are required to be offset by trading.

<sup>73</sup> See MGEX Rules 2101.00.C. and 718.01.



#### **D. Timeliness of Disciplinary Proceedings**

The Division found that the six investigations referred to the BCC and the one investigation referred to the FTCC during the target period all were handled in a timely manner once an investigation was submitted to a disciplinary committee. Five investigations were presented to the BCC and one investigation was presented to the FTCC within approximately one month of the date they were closed by A&I, and one was presented to the BCC within approximately two months of the date it was closed. Disciplinary action was completed in all seven matters within one month of their receipt by the BCC or FTCC.

#### **E. Conclusions and Recommendations**

The Division found that the MGEX disciplinary program includes appropriate disciplinary procedures. The Exchange has the authority to investigate possible rule violations, prosecute cases, and discipline members who are found guilty. Respondents receive adequate notice of the claims against them, and have sufficient opportunity to present their defenses, call witnesses, and offer evidence. Respondents also are afforded the right to counsel, may enter into settlement negotiations and may appeal unfavorable decisions to the Board.

The FTCC and BCC have the authority to conduct disciplinary hearings at the Exchange. The FTCC is responsible for matters concerning futures and option trading, including consideration of possible trading violations, while the BCC is responsible for all other potential violations, such as registration issues, clearinghouse matters, position limits, and margins.

During the target period, one investigation involving substantive trading violations and five investigations involving recordkeeping-type violations were referred to the BCC, and one investigation involving a member that failed to report trade activity on a trading card was referred to the FTCC. All seven cases resulted in settlements with sanctions that included fines

totaling \$12,750 and a 10-day suspension. The Division found that all of the disciplinary matters were resolved in a timely manner.

The Division is concerned about the adequacy of the sanctions in the six cases involving recordkeeping violations. The fines in those cases ranged from \$250 to \$750. The Division's concern is further exacerbated by the fact that two of the cases involved recidivist activity. In the first case, a clearing member that was fined \$500 for violating the Exchange's offset rules had previously been sanctioned by the Exchange on three separate occasions during the past six years for the same violation. In the second case, one of the clearing members that received a \$250 for failing to file an accurate position report with the clearinghouse received the identical fine for the same violation in 2005. In both cases, the BCC did not take into consideration the members' past disciplinary history from disciplinary cases that were older than two years. The Division believes that significantly larger sanctions were warranted in both cases. The Exchange should ensure that all sanctions are sufficient in magnitude to serve as an effective deterrent, particularly in those cases involving repeat offenders.

The Division also found that one member was given three staff warning letters and one staff reminder letter during an 11-month period for filing inaccurate position reports with the clearinghouse. A policy of issuing repeated reminder and warning letters to members who repeatedly violate the same or similar rules, rather than issuing meaningful sanctions, renders the Exchange's disciplinary program less effective.

The Division therefore recommends that:

- **The Exchange's disciplinary committees should ensure that all sanctions imposed in connection with disciplinary matters are of sufficient magnitude to serve as an effective deterrent.**

- **The Exchange’s disciplinary committees should review a member’s complete disciplinary history when determining appropriate sanctions and impose meaningful sanctions on members who repeatedly violate the same or similar Exchange rules to discourage recidivist activity.**
- **Absent extenuating circumstances, no more than one reminder letter and one warning letter should be issued in a rolling 12-month period before sanctions are imposed.**

## **IX. DISPUTE RESOLUTION**

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

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

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

#### **A. Arbitration Procedures**

MGEX provides dispute resolution services for resolving disputes between Exchange members and their customers through its Customer Claims Arbitration program (“arbitration program”). Customers of Exchange members can submit any dispute arising out of a trade made

on the Exchange for arbitration by filing a written complaint with the Exchange within two years after the date of the transactions from which the dispute arose. If a customer files an arbitration complaint, participation in the arbitration is mandatory for the member involved under Exchange rules.

Complaints are arbitrated by a Customer Claims Arbitration Panel consisting, of three Exchange members whose principal business activity is related to futures and options trading. Members are appointed to serve on the Panel by the Exchange's President or Secretary.<sup>74</sup> All proceedings are governed by the standards of the American Arbitration Association.

Written complaints, answers, and replies are served on both parties. Each side must cooperate in voluntary exchange of relevant documents and information, and the Exchange must make available any relevant documents in its possession.<sup>75</sup>

Complaints are heard in a hearing before the Panel, at which each party has the right to be represented by counsel and to present statements and question witnesses under oath. The Panel must issue a decision in writing as soon as practicable after the hearing. Decisions must be based on the record of the hearing, and are final and binding on the parties. No appeal is permitted except where required under applicable law.

There were no arbitrations at MGEX during the target period.

## **B. Conclusions and Recommendations**

The Division found that MGEX's rules provide fair and equitable procedures for the resolution of customer disputes. Each party has the right to counsel and each party receives adequate notice of the claims presented against them and an opportunity to be heard on all claims.

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<sup>74</sup> Members may not serve on a Panel for any matter with respect to which they have any conflict of interest, and ex parte contact with Panel members by either side during the proceedings is not permitted.

<sup>75</sup> In case of disputes regarding document production, the Panel has the power to subpoena documents it deems relevant.

MGEX's arbitration procedures require a prompt hearing and authorize prompt, written, final settlement awards that are not subject to appeal within the Exchange. Since there were no requests for arbitration filed during the target period, the Division was unable to evaluate the adequacy of the Exchange's dispute resolution program.