

Rule Enforcement Review of the Minneapolis Grain Exchange



Division of Trading and Markets

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RULE ENFORCEMENT REVIEW OF THE MINNEAPOLIS GRAIN EXCHANGE

I. INTRODUCTION – PURPOSE AND SCOPE

The Division of Trading and Markets ("Division") has completed a rule enforcement review of the market surveillance, trade practice surveillance and disciplinary programs of the Minneapolis Grain Exchange ("MGE" or "Exchange") for compliance with Sections 5a(a)(8) and 5a(b) of the Commodity Exchange Act ("Act") and Commission Regulation 1.51. In addition, the Division assessed the Exchange's audit trail and recordkeeping systems for compliance with Commission Regulation 1.35.¹ This review covers the period of October 1, 1999 to September 30, 2000 ("target period").² The Division's last rule enforcement review of the Exchange's compliance program was presented to the Commission on March 30, 1999 ("1999 Review").³

¹ On December 22, 2000, the President signed into law the Commodity Futures Modernization Act of 2000 ("CFMA"). The CFMA amends the Act and creates a new, flexible structure for regulation of futures trading. Among other things, the CFMA provides for a tiered regulatory structure that is tailored to the specific products and participants of a given market, taking into account the manipulability of the products and the relative sophistication of the participants. Under this framework, the Division will review the regulatory compliance programs of contract markets for adherence to core principles rather than to prescriptive regulations. The core principles applicable to contract markets such as MGE relate, among other things, to compliance with rules, monitoring of trading, position limitations or accountability, execution of transactions, recordkeeping, and protection of market participants. Since the target period for this rule enforcement review concluded prior to enactment of the CFMA, the Division has conducted this review based on the requirements of the Act and Commission regulations existing during the target period, rather than on the basis of the new legislation.

² 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. These reviews deal only with programs directly addressed in the review and do not assess all programs. The Division's analyses, conclusions and recommendations are based, in large part, upon the Division's evaluation of a sample of investigation files, disciplinary cases, 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.

³ A copy of the 1999 Review can be found in Appendix 1.

In the 1999 Review, the Division found that a significant number of the Exchange's investigations were not completed in a timely manner. Because the delays were largely attributable to high staff turnover, the Division recommended that MGE examine the underlying reasons for the large number of staff departures. The Division also recommended that MGE review and implement procedures that would significantly improve the timeliness of completion of investigations. In addition, the Division found that the Exchange issued multiple reminder and warning letters for repeated violations of the same rule. The Division recommended that the Exchange establish written guidelines or promulgate rules which would severely limit the number of disciplinary letters that can be issued to members before meaningful sanctions are assessed.

Notwithstanding the Exchange's positive written response to the prior recommendations, the Division found that the same deficiencies continued to exist during the current target period. In conducting its review, Division staff examined Exchange documents that included, among others, computer reports and other documentation used routinely in conducting trade practice and market surveillance; trade practice investigation and disciplinary action files;⁴ investigation, recordkeeping, audit trail, disciplinary, and floor surveillance logs; routine audit trail reviews and compliance manuals and guidelines. In addition, Division staff interviewed senior Compliance Division ("Compliance") officials, including the Vice President of Compliance.⁵

The Division provided the Exchange with the opportunity to review and comment on a draft of this report on May 3, 2001. On May 8 and 14, 2001, Division staff conducted exit conferences with MGE officials to discuss the report's findings and recommendations.

⁴ Division staff reviewed all disciplinary files for cases that became final during the target period. Division staff also reviewed all trade practice and "card order" ("recordkeeping") investigations that were closed during the target period.

II. MARKET SURVEILLANCE

A. Daily Surveillance Activities

Compliance's Audits and Investigations Department ("A & I") staff conducts daily market surveillance activities for MGE contracts in order to identify possible price manipulation or distortion, and to ensure an orderly liquidation of expiring contracts.⁶ In doing so, A & I focuses on the monitoring of volume and open interest, 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 uses several computer-generated volume and open interest reports to analyze potential market congestion and price distortion. The Open Share Of Market reports show the gross open positions for both house and customer accounts at each of the Exchange's clearing members.⁷ The reports are reviewed to detect any concentrations of positions at any one clearing member. A & I notes the three largest long and short positions in the nearby contract for both house and customer accounts on its Daily Market Surveillance Log ("DMSL").⁸ This information, along with the percentage of open interest held by each clearing member, is reviewed daily.

⁵ The transcripts of the October 30 and 31, 2000 interviews can be found in Appendix 2.

⁶ Futures contracts traded and the volume in each during the target period were: spring wheat (963,054 contracts), white wheat (2,194 contracts), durum wheat (1,516 contracts), cottonseed (329 contracts), electricity (on- and off-peak total- 330 contracts), white shrimp (66 contracts), and black tiger shrimp (40 contracts). Option contracts traded and volume during the target period were: spring wheat (42,752 contracts); cottonseed (729 contracts); white shrimp (61 contracts); black tiger shrimp (57 contracts); white wheat (51 contracts); and durum wheat (11 contracts).

⁷ There were 13 clearing members during the target period. A copy of the Open Share Of Market reports for house and customer accounts can be found in Appendix 3.

⁸ A copy of the DMSL can be found in Appendix 4.

A & I staff also reviews daily all open contracts for any significant changes in clearing member open interest.⁹ A significant change is then analyzed to ascertain the underlying reason for the change and the effect on the market, if any. A & I reviews the Volume And Open Interest By FCM and the Volume And Open Interest By Commodity reports, which detail, by clearing member or commodity, for each contract month (by strike price for options), the gross volume of trades, transfer trades, deliveries and delivery intentions (exercises for options), exchanges of futures for physicals (“EFP”), and ending long and short positions. The reports enable A & I to monitor changes in a clearing member's open position by analyzing the components of such changes. Staff also considers external factors that may impact the market, such as economic news, weather, or domestic and foreign market crises.

2. Price Changes And Inter-Market Relationships

To detect unusual price movements and/or aberrations in price relationships that could reflect an underlying problem, A & I reviews price changes and spread relationships. If substantial differences in price relationships are detected, staff investigates to ascertain the possible reasons for the discrepancies and evaluates the effect on the market, if any, particularly in the nearby month. A & I staff records daily price ranges and settlement prices for all futures traded on the Exchange. A & I calculates and records the change in settlement prices for each 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.

⁹ An increase or decrease of 30% or more in the total open interest in any contract month is considered to be a significant change.

In addition, A & I staff records daily price ranges and settlement prices for the Chicago Board of Trade (“CBT”) and Kansas City Board of Trade (“KCBT”) wheat markets. Inter-market spread relationships are monitored by A & I staff by comparing, by contract month, the MGE spring wheat to the CBT and KCBT markets. Further, A & I monitors inter-commodity spread relationships by comparing the spring wheat to the white wheat and durum wheat prices, and the white shrimp to the black tiger shrimp prices. No significant price abnormalities were noted in any MGE market during the target period.

3. Deliverable Supplies

Using data compiled from MGE Form 38M submitted by grain elevator operators, A & I staff prepares the "Stocks Of Grain Report" for its spring wheat contract. This weekly report of stocks of grain in deliverable position in Exchange-approved warehouses details the deliverable grades, non-deliverable grades/ungraded and Commodity Credit Corporation stock. For comparative purposes, the report also includes statistics from the previous week and a year ago. In addition to determining whether there are sufficient stocks of grain available for delivery, A & I assesses tight supplies and/or concentrated ownership that could make the market susceptible to manipulation.

In addition to Form 38M, each licensed public warehouse in the Minneapolis/St.Paul/Red Wing and Duluth/Superior switching districts (the delivery points for the spring wheat contract) is required to transmit a weekly report of all grain stocks to the Exchange Weighing Department. This information is compiled into one report and is provided to A & I. Staff then compares it to the Stocks Of Grain Report to detect any significant discrepancies. If discrepancies are identified, A & I notifies the Vice President, Market Regulation, for further follow-up. However, there were no significant discrepancies identified during the target period.

4. Heightened Surveillance of Expiring Contracts

Heightened surveillance of an expiring contract generally begins when a futures contract becomes the nearby contract, e.g., increased surveillance of the December 2000 spring wheat futures contract began in the last week of September 2000 when the September 2000 spring wheat futures contract expired. Enhanced option surveillance begins on the first day of the month the option contract expires, e.g., increased surveillance of the December 2000 option contract began on November 1, 2000.

A & I utilizes several computer-generated reports to ensure that futures contracts are liquidated in an orderly fashion and that option contracts are exercised in accordance with Exchange rules and regulations. A & I staff reviews the previously described Open Share Of Market and Volume And Open Interest reports to detect potential concentrations of positions among clearing members. If a clearing member has 75 percent or more of the open interest in an expiring futures contract, A & I generally will contact the clearing member to determine the intentions of the clearing firm'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 weekly, and more often if necessary, the Account Name Position Analysis Report.¹⁰ The report lists the position holder, account number, net position, and the percentage of the market held in each commodity and contract month. This information is used by A & I to identify position holders and to evaluate their ability to make or take delivery. A & I also conducts a comparison of open interest in expiring contracts to the weekly Stocks Of Grain Report to ascertain whether there is an adequate supply of grain with dispersed, rather than concentrated, ownership.

With regard to expiring option contracts, A & I reviews weekly the Delta Position Large Trader Report, which lists all option traders holding reportable option positions.¹¹ The report lists the expiration date, number of option contracts held, designation of commercial or noncommercial account, FCM code, CFTC ID number, delta (call/put)¹² and futures equivalent positions. The report enables A & I to monitor the largest short put and call holders for both house and customer accounts. A & I also reviews the Exercise Trade Register Report, which lists the clearing member, premium, quantity, account number, and exercise dollar amount for all options that are exercised.¹³ The report is reviewed to ensure that options are properly exercised, particularly those occurring on the last trading day. Finally, A & I reviews the Report Of Exercises, a summary report of all exercises for the day. Published daily by the clearinghouse, this report details each clearing member's option positions that were exercised, including the opposite clearing member, option contract exercised, contract month, quantity and strike price.¹⁴

Approximately a week before expiration, an Options Expiration Reminder is sent to each clearing member to remind them of the requirements for option expiration.¹⁵ Pursuant to MGE rules, the clearinghouse automatically exercises in-the-money options in all MGE option contracts, unless notice to cancel automatic exercise is given by the carrying clearing member to the clearinghouse. Each clearing member is also sent an In-The-Money Report Summary, which shows the FCM code, the number of long and short option positions, house or customer, and the

¹⁰ A copy of the Account Name Position Analysis Report can be found in Appendix 5.

¹¹ A copy of the Delta Position Large Trader Report can be found in Appendix 6.

¹² An option delta represents the amount an option premium will change with a given change in the underlying futures price.

¹³ A copy of the Exercise Trade Register Report can be found in Appendix 7.

¹⁴ A copy of the Report of Exercises can be found in Appendix 8.

¹⁵ Copies of the Option Expiration Reminder memorandum and the In-The-Money Report Summary can be found in Appendix 9.

settlement price of the expiring contract. A & I verifies that the clearinghouse received a written notification from the carrying clearing member in the event that an in-the-money option is not automatically exercised. During the target period, all MGE futures and option contracts liquidated in an orderly manner.

B. Large Trader Reporting and Speculative Limit Enforcement

A & I monitors reportable futures and option positions by reviewing the aforementioned Account Name Position Analysis Report and the Delta Position Large Trader Report. These reports reflect, among other things, each reportable account and position by clearing member. A & I also receives a report of reportable positions in futures and options from the Commission's Kansas City office on a weekly basis or more often as needed. Commission staff compiles the report from the data it receives on reportable accounts from FCMs and clearing members pursuant to Part 17 of the Commission's regulations. Each of these reports are reviewed by A & I staff to monitor the activity of large traders, identify possible position concentrations that may disrupt the market, and enforce Exchange speculative position limit rules.

With respect to speculative position limits, because the majority of trades at MGE involve major agribusiness firms that utilize the marketplace for hedging purposes, the sum total of speculative positions is significantly less than at other exchanges. In fact, no individual accounts approached the speculative limits during the target period. Nevertheless, A & I continues to monitor for compliance with speculative position limits.¹⁶ For futures contracts, A & I reviews the Open Share Of Market reports, as well as the Account Name Position Analysis Report, for compliance with speculative position limits on a daily basis. For option contracts, A & I reviews the Delta Position Large Trader Report. If an individual account should approach

the speculative limit, A & I staff will contact the clearing member to ascertain whether the clearing member has a hedge exemption on file for that account. Should a speculative limit violation be found, an investigation will be opened and the matter referred to a disciplinary committee for further review and possible action.

C. Monitoring of EFP Transactions

Pursuant to MGE Rule 719.00 and Regulation 2057.00, EFPs are ex-pit transactions at a price agreed upon by the parties to the trade. Under Exchange rules, the futures side of the transaction will be priced within the trading range that occurred during the trading session, unless otherwise agreed to by both parties. EFP trades at MGE typically are used by commercials who have hedged their cash positions in the futures market. Trade data for an EFP transaction are transmitted to the clearinghouse and must include the clearing member, price, quantity, commodity, contract month, and the appropriate symbol indicating that the trade was an EFP.

A & I employs two procedures for monitoring EFPs. First, A & I examines EFPs in conjunction with its annual recordkeeping review of order tickets and trading cards at each clearing member.¹⁷ In its recordkeeping review, A & I requests the underlying documents¹⁸ for all EFPs transacted by each clearing member, reviews the documents to verify the bona fides of the EFPs, and retains copies of the documents in the investigation files. Resultant findings are detailed in the accompanying investigation reports regardless of whether problems are detected.

¹⁶ The Exchange has adopted the federal speculative limits set forth in Commission Regulation 150.2.

¹⁷ See pp. 13-14 for a discussion of recordkeeping reviews.

¹⁸ Underlying documents are defined in MGE Regulation 2057.00 as those documents customarily generated in accordance with cash market practices which demonstrate the existence and nature of the underlying cash transactions including, but not limited to, contracts, confirmations, invoices, warehouse receipts, telex printouts, or other documents of title.

Second, as part of its daily review of the Time Audit Report ("TAR"), the Exchange's trade register, for possible trading violations, A & I staff looks for EFPs with unusual characteristics that may warrant investigation.¹⁹ For example, A & I may investigate EFPs that show the same account 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 and/or account owners to request documentation to ascertain the bona fides of the EFP.

Under both procedures, there were no EFPs that warranted investigation during the target period. Division staff reviewed each of the 13 recordkeeping reviews and, likewise, did not find any suspicious EFPs.

D. Conclusions And Recommendations

The Division found that the Exchange maintains an adequate market surveillance program. The Exchange utilizes various computer-generated reports to monitor daily price changes, spread differentials, open interest, volume, and deliverable supplies. The Exchange also increases the level of its market surveillance activities during the delivery month, focusing on the ability of short position holders to deliver and the availability of deliverable supplies. In addition, the Exchange has adequate procedures for monitoring reportable positions and reviewing EFP transactions.

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

¹⁹ A copy of the TAR can be found in Appendix 10.

III. AUDIT TRAIL AND RECORDKEEPING

A. Essential Trade Data

MGE Regulation 2062.00 requires that each floor member record all essential trade data for the execution of personal trades on a pre-printed sequenced trading card.²⁰ Typically, an order ticket is used to record the execution of orders for a house account, customer, or another member on the floor. The trading cards are collected by clearing members within 15 minutes of each 30-minute interval, and clearing members submit the trade data to the clearinghouse through the Exchange's automated trade data entry and matching system ("TEMS").

TEMS allows clearing members to enter data directly from trading cards and order tickets into computer terminals located typically in the clearing firm's booth on the trading floor. MGE Resolution 2101.00.C requires that trades be entered into TEMS within 45 minutes of the conclusion of each 30-minute interval. For those clearing firms for which any unmatched trades remain in TEMS at the end of the trading day, the clearinghouse provides, at 2:15 p.m., the MGE Unmatched Trade Register for futures and options, along with the Recapitulation Report.²¹ Clearing firms have until 3:00 p.m. to correct unmatched trades. The Division found that there were no significant unmatched trade problems during the target period.

B. Time of Execution

MGE Regulation 2062.00 and Rule 756.00 require that each member manually record the time of execution for personal trades on trading cards, and the time of execution for other trades

²⁰ The trading card reflects essential trade matching data, including the commodity, date, identity of the executing and opposite brokers, contract month, and price (or, in the case of spreads, the differential). For option trades, the trading card also reflects the premium and a put/call indicator.

²¹ The Recapitulation Report actually comprises several reports: the General Recapitulation report summarizes the positions held; the Bought Settlement report and the Sold Settlement report detail the daily trading activity of bought and sold trades; and the Report of Ex-Pit Transactions details EFPs, as well as transfer trades. Clearing firms receive a separate "recap report" for segregated (customer) futures, regular (house) futures,

on order tickets. The time of execution and other recorded trade data are then entered into TEMS and compared to the Time and Sales Report (“time and sales”)²² to create the TAR. The TAR details all futures and option trades in chronological order. The TAR also 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 can be made between the trades reported by the members on their trading records and the prices and times of execution recorded in the time and sales.

The TAR generates five timing error codes which identify possible inaccurately reported times of execution, such as where a member fails to record a time or a recorded time is more than one minute from the nearest time and sales print. A & I reviews trades that are assigned these codes to enforce its trade timing requirement and to calculate the Exchange’s accuracy rate. The Exchange calculates trade timing accuracy for each side of a trade. If one side of a trade is flagged with an error code and the other side is not flagged, the execution time of the side with the error code would be deemed to be inaccurate, and the error-free side would be accepted as accurate. If an error code applies to both sides of a trade, both sides would be counted as inaccurate.

Compliance reviews the trading activity of members whose timing error rates exceed specified daily or monthly thresholds.²³ If a member’s timing error rates exceed the daily or

segregated options and regular option positions. Copies of the Unmatched Trade Register and Recapitulation reports can be found in Appendix 11.

²² MGE Rule 725.01 requires that each party to a futures transaction made competitively in the pit must promptly notify the market observer(s) of the price at which the trade has been executed. Thus, MGE’s time and sales captures all trade executions, not just price changes within the market.

²³ On a daily basis, a member with an overall 20 percent timing error rate and at least 20 timing errors will be investigated unless the member already is the subject of an open investigation. On a monthly basis, a member with an overall ten percent timing error rate with at least 20 timing errors may be investigated. In addition, all trades which clear without trade times or which otherwise appear suspicious will be investigated.

monthly threshold, Compliance first examines the underlying trade documents and determines the “audited” error threshold, which discounts, among other things, errors caused by keypunching. If the audited error rate is found to be between two and five percent, the member is sent a reminder letter. If the audited error rate is between five and eight percent, the member is sent a warning letter. If the audited timing error rate exceeds eight percent, the member is subject to being forwarded to a disciplinary committee for disciplinary action.

The Exchange closed four investigations that were generated by members who exceeded the timing error rate thresholds. As a result, MGE issued three warning letters and one reminder letter to four members and two reminder letters to two clearing member firms. The small number of investigations in this area can be attributed to the continued high rate of compliance by MGE members in recording trade execution times. In this regard, the Exchange’s monthly timing accuracy rate for all futures and option transactions ranged from 95.2 percent to 98 percent, with an overall accuracy rate of almost 97 percent.²⁴

C. Floor Order Tickets And Trading Cards

MGE conducts an audit of each clearing firm at least once a year for compliance with Exchange order ticket and trading card recordkeeping requirements. During the audit, the Exchange reviews an entire day’s worth of order tickets and trading cards. Generally, the day chosen for review is randomly selected.

The Division reviewed 13 recordkeeping reviews of 11 clearing firms completed during the target period and found a high rate of compliance with applicable Exchange requirements. Specifically, the Exchange examined a total of 228 filled order tickets and 132 trading cards in

²⁴ This accuracy rate is based on data provided by the Exchange for all contracts on two representative trade dates in each month during the target period.

the 13 reviews.²⁵ All of the order tickets contained account identification; 227 (99.6 percent) contained a timestamp upon receipt; 220 (96.5 percent) contained a timestamp upon report of execution; and 211 (92.5 percent) reflected a manual time of execution.

With respect to trading cards, the Exchange found that 129 (97.8 percent) contained opposite broker numbers; 127 (96.2 percent) contained no unused lines that were not crossed out on either the buy or the sell side; 126 (95.5 percent) contained execution times; 125 (94.7 percent) contained recorded trades from only one 30-minute trading interval; and 127 (96.2 percent) were submitted to the Exchange within the required 15-minute interval.

D. Conclusions And Recommendations

The Division found that MGE maintains an adequate program for enforcing compliance with its one-minute trade timing rule. The Exchange utilizes a computerized verification program to monitor and enforce timing compliance. During the target period, Exchange members maintained an average trade timing accuracy rate of almost 97 percent.

The Division also found that the Exchange has adequate procedures to assess and enforce member compliance with MGE order ticket and trading card recordkeeping requirements. Generally, the Exchange reviews each clearing firm's compliance at least once a year, selecting all orders and trading cards for one day. During the course of 13 recordkeeping reviews completed during the target period, the Exchange found compliance rates in the mid to high 90 percent range.

Accordingly, the Division has no recommendations in this area.

²⁵ In addition to the 228 filled order tickets, MGE reviewed 126 order tickets that were marked unabled; 17 order tickets that were cancelled; 41 order tickets that documented EFP transactions; and five order tickets that were voided.

IV. TRADE PRACTICE SURVEILLANCE

A. Compliance Staff

The Vice President, Market Regulation (“Vice President”), joined the Exchange in 1987, became Compliance Director in 1991, and assumed his current position in June 1997. The Vice President reports to the Exchange President and is responsible for the oversight and management of the Exchange’s market surveillance, audit trail, trade practice surveillance, financial surveillance and disciplinary programs. The Vice President heads Compliance, which is comprised of two departments: A & I and the Exchange Room.²⁶ A & I staff are responsible for surveillance and investigative matters, and Exchange Room staff are primarily responsible for capturing and disseminating price information on the trading floor. The Vice President determines whether an investigation should be initiated where questionable trading activity arises and establishes the scope of the investigation. In addition, the Vice President is responsible for the prosecution of possible trading violations before the Exchange’s disciplinary committees.

Compliance includes three managers, two in A & I, and one who is in charge of Exchange Room operations. Within A & I, one manager is responsible for guidance on surveillance matters, reviewing investigations, special projects, and handling duties for the Vice President in his absence. The other is responsible for reviewing investigations, special projects, and hiring and training of Compliance staff. Three full time investigators report to the A & I managers, and four full time Exchange Room clerks, who are responsible for trading floor duties, report to the third manager.

²⁶ The term “Exchange Room” refers to the Exchange’s trading floor.

B. Automated Surveillance

The Exchange has two main reports that it uses to identify possible trade practice abuses and other trading irregularities for further investigation: the TAR and the Broker Error Type Report (“BETR”). As stated above, the TAR is a single report that combines the details of all futures and option trades with time and sales data. In addition to the previously described timing error codes, the TAR contains codes that identify possible substantive trade practice abuses. These codes, which are generated when preset parameters are met, include the following: “ACC” for accommodation trading, “WSH” for wash trading, “BTA” or “STA” for buyer or seller trading ahead, “MPS” for money pass, “IRG” for invalid ring trade, “ISP” for invalid spread, “PAH” for price above daily high, “PBL” for price below daily low, and “PTE” for post settlement trade error. The BETR is derived from the TAR and provides, by member, the number of codes attributable to each member.

The Exchange reviews the TAR and BETR daily, and reviews the trading activity of members whose error rates exceed specified daily or monthly thresholds. On a daily basis, a member with an error code rate above ten percent of his or her daily volume will be reviewed for possible trading violations. If no problems are found, Compliance documents its findings with a note on the TAR. If a code or situation indicates suspicious activity, Compliance will request trading records for review and could initiate an investigation. On a monthly basis, a member with a monthly combined error rate of five percent or more may be targeted for investigation, if he or she is not already the subject of an investigation based upon the daily ten percent threshold.

C. Floor Surveillance

Compliance staff conducts floor surveillance during the opening and closing of the markets and at three randomly selected times during the trading session. Typically, an

investigator will be on the trading floor five minutes prior to the open and will remain there approximately 10-15 minutes after the open. At the close, an investigator will be on the trading floor for up to 15 minutes before the close and will remain through the post-settlement session.

The Exchange documents floor surveillance observations in two logs. Prices, price changes and floor observations reflecting market conditions are documented in the “market log.” Individual badge numbers of the traders present on the floor are recorded in the “pit population log.” The pit population log can be used by Compliance, if necessary, to verify that a member was in a particular pit at the time of a trade that is under investigation. Although no investigations were opened based on floor surveillance, the pit population and market logs were used during the course of several investigations to confirm the presence of certain members in the pit.

D. Adequacy And Timeliness of Investigations

1. Adequacy

During the target period, the Exchange opened 40 investigations and closed 50. The Division reviewed the adequacy of the latter 50 investigations, and found that they were generally thorough and well documented. The investigation files contained all the appropriate time and sales reports, copies of the TARs, computer generated surveillance reports, pertinent underlying trading documents, work papers, exhibits, summaries of interviews and an investigation report.

Thirty-four of the 50 closed investigations resulted in the issuance of 30 staff warning letters and 42 staff reminder letters. Of the 34 investigations in which the letters were issued, 12 were internally generated based upon reviews of the TAR; 11 resulted from routine recordkeeping reviews of the clearing firms; four were routine investigations opened based on

exceeding the acceptable error code threshold rates; two involved member complaints, and five were initiated by staff for other reasons. Fifteen investigations resulted in no action taken, and one investigation was referred to a disciplinary committee. The latter case involved an individual who was fined \$1200 for placing bids and offers prior to being approved for MGE membership.

With respect to the 40 investigations opened during the target period, 11(28 percent) of the investigations were internally generated based upon reviews of the TAR; 13 (33 percent) resulted from routine recordkeeping reviews of the clearing firms; eight (20 percent) were routine investigations opened based on exceeding the acceptable error code threshold rates; two (five percent) involved customer complaints, and six (15 percent) were initiated by staff for other reasons.

2. Timeliness

In the 1999 Review, the Division found that Exchange investigations should be completed in a more timely manner. The Division found that most of the delays in closing investigations were attributable to four factors: (1) high staff turnover, (2) lengthy supervisory review, (3) delays in the reassignment of investigations upon the departure of staff members, and (4) compliance staff time spent on other assignments, such as special projects and committee work. Further, the Division found that delays in completing investigations occurred because of lengthy time lags between first-line supervisory review and final review and sign-off by the Vice President. As stated earlier, the Division recommended that the Exchange review its procedures for monitoring the progress of an investigation, for supervisory review, and for reassigning investigations, and implement procedures that would significantly improve the timeliness of completing investigations.

In June 1999, the Exchange responded positively to these recommendations and, in order to complete investigations in a more timely manner, implemented changes in its process of supervisory review.²⁷ Specifically, the Exchange stated that an additional Compliance staff member (now one of the managers) had been given the authority to conduct supervisory reviews of completed investigations. This allowed for two individuals to review completed investigations.²⁸ Additionally, Compliance shortened the length of time given to staff investigators to complete assigned investigations and the Compliance Managers began to monitor more closely each staff investigator's deadlines to ensure timely completion of assigned investigations.

Notwithstanding these changes, during the course of this review, the Division found 11 investigations that were not complex in nature and did not require extensive analysis or document requests that were open for an unduly long period of time.²⁹ Each of the investigations were open for more than one year, including two that were open more than two years and two others that were open almost two years.³⁰ Five of the investigations involved firms failing, in single instances, to report correct data to the Exchange clearinghouse; three were

²⁷ Letter dated June 4, 1999, from James H. Lindau, President and Chief Executive Officer, MGE, to Alan L. Seifert, Deputy Director, Division of Trading and Markets ("MGE response letter"). A copy can be found in Appendix 12.

²⁸ The Exchange represented that this change would reduce the time it takes to complete investigations since more investigations could be reviewed at the same time, thereby shortening the length of time between submission of the investigation by the investigator and completion of supervisory review by the reviewer.

²⁹ The Division is concerned that Exchange investigations be completed in a timely manner for three reasons. First, the Division believes that prompt investigations lead to more prompt disciplinary actions, which are necessary to discourage continued violations of the same or similar rules. Second, unduly long delays often prove detrimental to the quality of an investigation and to an Exchange's potential disciplinary action because, over time, witnesses tend to forget or are unable to recall the precise circumstances under which trades in question took place. Third, evidentiary trading documents necessary to the success of a case may be misplaced or otherwise cannot be located.

³⁰ Investigation 99-I-0004, open for 379 days; 99-I-0033, 398 days; 99-I-0016, 529 days; 99-I-0019, 534 days; 99-I-0015, 539 days; 99-I-0014, 553 days; 99-I-0013, 556 days; 98-I-0050, 646 days; 98-I-0049, 695 days; 98-I-0023, 844 days; and 98-I-0017, 869 days.

generated by single trades that resulted in the appearance of miscellaneous and timing error codes on the TAR; one was opened because three trades were assigned miscellaneous error codes indicating possible trading ahead; one was initiated when a member exceeded the timing error rate threshold; and one was opened when a member who was not registered was observed placing bids in the pit. Of the remaining 39 investigations that were closed during the target period, 26 were closed within four months and 13 were closed between four months and one year. One investigation involving possible trading ahead and prearranged trading by three members that was still open at the end of the target period, had been open for 638 days.³¹

The Division reviewed the 11 investigations to determine, among other things, the reasons for the Exchange's failure to complete the investigations in a timely manner. Based upon a review of the cover sheets in the investigation files that provides a time line for the progress of each investigation, in nine of the 11 investigations, it took between nine and 20 months from initial completion by the investigator to final review and approval by the Vice President. The cover sheets, however, do not provide an explanation for the delay between investigation completion and sign-off by the investigator and final review and approval by the Vice President, particularly the delay between the initial and any subsequent sign-off by the Compliance Manager.³² The Exchange represents that these delays may occur when an investigation is sent back to the Compliance Manager by the Vice President for additional

³¹ This investigation, 99-I-0001, was subsequently closed on April 4, 2001, thus remaining open for a total of 820 days. No violations were found; however, the three members were given verbal warnings by compliance staff.

³² A staff investigator initials and dates the line labeled "investigator" on the cover sheet when he submits his initial findings to a Compliance Manager. This is only considered an initial submission since the file may be returned to the staff investigator if further analysis is warranted. The Compliance Manager initials and dates the line labeled "reviewer" on the cover sheet when the file is submitted to the Vice President for final review. The file still may be returned to the Compliance Manager for further analysis. The Vice President also initials and dates the line labeled "reviewer" when the investigation is complete and requires no additional work. The investigation is officially closed when the Vice President initials and dates the line labeled "approval." A sample cover sheet can be found in Appendix 13.

analysis. Although it is difficult to discern when this occurs, a review of the 11 cover sheets indicates only that all of the investigations were reviewed more than once by the Compliance Manager following completion by the initial investigator.

In addition, the investigation files do not contain an adequate explanation of the specific reasons for not completing investigations more promptly. The file for each investigation open more than 120 days included only a standard memo stating that the investigation was not closed within the normal four-month guideline due to a number of “unanticipated or unusual circumstances.” The Exchange, however, gave no explanation other than “unanticipated or unusual circumstances” for the lengthy delay in eight of the 11 investigations that took over a year for final review and approval. Consequently, the Division could not identify specific reasons for the delays, other than supervisory review, in completing those investigations.

E. Conclusions And Recommendations

With the exception of several unduly long investigations, the Exchange maintains an adequate trade practice surveillance program. The Exchange’s investigations were thorough and well documented, and contained appropriate analyses. In addition, the Exchange’s automated surveillance system generated a significant number of possible violations for further investigation.

However, as the Division found in the 1999 Review, the Exchange has difficulty completing investigations in a timely manner. Several investigations that were not complex and did not involve extensive analysis or document requests took a long period of time to resolve. These investigations had large unexplained time gaps between the date the investigator completed the investigation, the dates of initial and subsequent reviews by a Compliance Manager, and the date of final review and approval by the Vice President. The time span

between initial completion of the investigation and final review and approval ranged from approximately nine to 20 months. Finally, the Division found that the investigation files did not contain adequate explanations to document such delays.

Therefore, based on the foregoing, the Division recommends that MGE:

- Complete investigations in a more timely manner, including taking steps to reduce the lengthy delay between initial completion of the investigation by the investigator and final review and approval.

In order to monitor the Exchange's progress in this area, the MGE must provide a quarterly report to the Division, effective October 1, 2001 and until further notice, which lists all investigations open more than one year, the possible violation(s) involved, the investigative work performed to date, and an explanation for the investigation remaining open.

V. DISCIPLINARY PROGRAM

A. Disciplinary Committees and Procedures

The Exchange has two primary 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, position limits and margins.³³

Upon receiving an investigation report, the appropriate Committee may direct A & I to gather additional information, close the investigation because no reasonable basis exists for taking disciplinary action, issue a notice of charges, or send a reminder or warning letter. The notice of charges sets forth the alleged violative conduct and the rules and regulations believed to

³³ The FTCC consists of seven members, including the Chairperson of the Board of Directors ("Board"), the Exchange President, and five members 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. A committee member in either the BCC or the FTCC may not participate as a member of the Committee if the member has a financial, personal, or prejudicial interest or

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. At the discretion of the appropriate Committee, A & I may be given authority to negotiate and/or enter into a settlement with the respondent after a notice of charges has been issued.

Following a hearing, the Committee may close the case based upon its findings that no violations occurred or may take disciplinary action. If the Committee finds that there has been a violation, the Committee may issue a letter of reprimand, a monetary fine, a suspension from membership, or a recommendation to the Board for expulsion. Any suspension of 30 days or more, any fine of \$10,000 or more, or any expulsion is subject to approval by the Board.³⁴

B. Adequacy of Sanction Imposed

During the target period, the Exchange referred one investigation to the FTCC. Investigation 99-I-0045 concerned a trader who had not been approved for membership by the Board who allegedly placed bids and offers in the Twin Cities Electricity futures contract. After a review of the investigation report, the FTCC issued a notice of charges. The respondent entered into a settlement agreement that included a fine of \$1200.

C. Reminder and Warning Letters

In the 1999 Review, the Division found that the MGE issued multiple staff reminder letters (“SRL”) and staff warning letters (“SWL”) to several members who appeared to have repeatedly violated Exchange rules, particularly MGE Rule 725.01. Rule 725.01 requires each

concern in the matter before the Committee. The Committees determine whether any of their members has such an interest or concern.

³⁴ The respondent can appeal the findings or penalty imposed by the Committee to the Board. However, appeals are heard at the discretion of the Board. The Board’s decision on the appeal is based on the record of the hearing. If the respondent does not file an appeal, the penalty becomes effective on the date set forth in the Committee’s decision.

party to a futures transaction to promptly notify the market observer(s) of the price at which the trade has been executed. The Division recommended that the Exchange establish written guidelines or promulgate rules to severely limit the number of disciplinary letters which can be issued to members before meaningful sanctions, such as monetary penalties or suspensions, are assessed.

The Exchange responded by instituting written guidelines to address the type of disciplinary actions investigators should recommend when a member is in apparent violation of MGE Rule 725.01.³⁵ The guidelines were implemented on June 1, 1999. The guidelines state that members whose transactions clear outside the day's reported trading range who had no prior disciplinary history of violations of Rule 725.01 would be presented an SWL during a meeting with an A & I staff member. The member would also be informed at the meeting that the next such violation would be forwarded to a disciplinary committee for review and potential disciplinary action.³⁶ Those members who had a disciplinary history would be presented to a disciplinary committee for review and potential disciplinary action.

If the price of the transaction was within the day's reported trading range, an SRL generally would be issued if the member had received two or fewer disciplinary letters during the preceding three years. If the member had been issued more than two disciplinary letters over the three-year period, the member would be presented an SWL at a meeting with staff, at which time staff would also reiterate the member's reporting obligations. If another violation occurs within 12 months of the warning letter, an investigation into the member's activity is opened, which may result in referral to a disciplinary committee.

³⁵ MGE response letter. These guidelines were part of an approach by the Exchange to seek stronger disciplinary actions against repeat offenders of MGE Rules and Regulations.

³⁶ According to the guidelines, the investigator also has the latitude to recommend that the investigation be

Subsequent to the issuance of the guidelines, the Exchange continued to issue multiple SRLs and SWLs. For example, one member, who since 1997 had been issued one SRL and six SWLs for Rule 725.01 violations, was issued another SWL during the target period for a violation that preceded the guidelines.³⁷ Another member, who since 1997 had been issued three SRLs for MGE Rule 725.01 violations, was issued three SWLs during the target period for violations that preceded the guidelines.³⁸ Finally, a third member, who since 1997 had been fined once and issued eight SWLs for MGE Rule 725.01 violations, also was issued another SWL for violations that preceded the guidelines.³⁹ In total, approximately nine members or about 20 percent of the typical floor population fit into this category.

In addition to issuing multiple disciplinary letters, the Division found that the Exchange does not issue disciplinary letters or recommend sanctions for violations found in a current investigation if an SRL or SWL has recently been issued for a similar violation found in an investigation opened subsequent to, but closed prior to, the current investigation. In investigation 99-I-19, A & I found that two members (“Member A” and “Member B”) violated MGE Rule 725.01.⁴⁰ On September 29, 2000, Member A was issued an SWL. No action was taken with respect to Member B because he had been hand-delivered an SWL on September 27, 2000 for another violation of the same rule as a result of investigation 00-I-0014, which was opened subsequent to, but closed prior to, investigation 99-I-19.⁴¹

forwarded to a disciplinary committee after the first violation of Rule 725.01.

³⁷ The member has also been issued seven letters for 12 recordkeeping violations since 1997.

³⁸ The member has also been issued 12 letters for 22 recordkeeping violations since 1998.

³⁹ The member has also been issued seven letters for 14 recordkeeping violations since 1998.

⁴⁰ This investigation remained open for 539 days.

⁴¹ Member B was issued six SWLs for MGE Rule 725.01 violations in 1998. The SWL issued on September 27, 2000 was issued since implementation of the written guidelines.

Similarly, in investigation 99-I-0039, Member B and two other members (“Member C” and “Member D”) were investigated to determine whether they had violated MGE Rule 725.01.⁴² Member C was issued an SRL on September 29, 2000, but no action was taken with respect to Members B or D. A & I staff indicated that Member B, as noted above, had been hand-delivered an SWL on September 27, 2000, for another violation of the same rule as a result of investigation 00-I-0014, which was opened subsequent to, but closed prior to, investigation 99-I-39. Thus, even though Member B was found to have violated MGE Rule 725.01 in three different investigations, he was issued only one SWL. Further, because Member D had been issued an SRL on July 31, 2000 for another violation of the same rule as a result of investigation 99-I-0048, which was opened subsequent to, but closed prior to, investigation 99-I-39, no action was taken with respect to the current finding of a violation.

In failing to issue disciplinary letters in such instances, the Exchange causes inaccurate member disciplinary histories, may not consider relevant disciplinary information, and impedes its ability to properly apply its guidelines. When a member’s disciplinary history is not accurately documented, the ability to issue meaningful sanctions and to deter similar future misconduct is hindered.

D. Conclusions And Recommendations

The Division believes that the Exchange’s disciplinary program is not operating in an effective manner. The MGE continued to issue multiple reminder and warning letters to the same members for repeated violations of the same rule. The Division believes that issuing multiple disciplinary letters for such violations does not serve as an effective deterrent.

⁴² This investigation remained open for 350 days.

The Division also found several instances in which MGE failed to issue disciplinary letters to members who were found to have committed violations, but who had recently been issued a letter for another violation of the same rule as a result of a subsequently opened investigation. This practice creates a record that does not accurately reflect a member's disciplinary history, and impedes the Exchange's ability to properly apply its guidelines.

Accordingly, the Division recommends that MGE:

- Enforce its guidelines that limit the number of staff reminder and warning letters that can be issued to members for repeated violations of the same rule, and impose meaningful sanctions on such members.
- Issue disciplinary letters or recommend sanctions when appropriate for violations found in an investigation, regardless of whether a staff reminder or warning letter has been recently issued for the same violation as a result of a subsequently opened, but previously closed, investigation.