

**RULE ENFORCEMENT REVIEW  
OF  
ELX FUTURES, L.P.**



**Division of Market Oversight  
September 6, 2013**

**RULE ENFORCEMENT REVIEW OF  
ELX FUTURES, L.P. – MARKET SURVEILLANCE**

**Commodity Futures Trading Commission- Division of Market Oversight**

<b>I. INTRODUCTION.....</b>	<b>4</b>
<b>II. METHODOLOGY .....</b>	<b>6</b>
<b>III. SUMMARY OF FINDINGS AND RECOMMENDATIONS .....</b>	<b>8</b>
<b>IV. ELX OPERATIONS .....</b>	<b>13</b>
A. ELX Designation as a Contract Market .....	13
B. Products and Trading Volume During the Target Period .....	14
C. ELX Governance .....	16
1. ELX Ownership and Board of Directors .....	16
2. Regulatory Oversight Committee .....	17
<b>V. MARKET SURVEILLANCE PROGRAM.....</b>	<b>19</b>
A. Market Surveillance Staffing .....	19
1. ELX Compliance Department Staff and Responsibilities .....	19
2. NFA Compliance Staff and Coordination with ELX.....	21
B. Market Surveillance Inquiries and Investigations.....	24
1. Overview of Market Surveillance Inquiries and Investigations .....	24
2. Adequacy of Inquiries and Investigations.....	27
a. Inquiries and Investigations Reviewed by the Division .....	27
b. Inquiries Closed by NFA During the Target Period .....	28
c. Investigations Closed by NFA During the Target Period.....	30
d. Exchange Review of NFA Inquiries .....	31
e. Exchange Review of NFA Investigations.....	32
3. Inquiry and Investigation Logs and Reports .....	34
a. NFA’s Case Ageing Report .....	34
b. The Exchange’s Investigation Log .....	34
c. Adequacy of Inquiry and Investigation Logs and Reports .....	35
4. Timeliness of Completing Inquiries and Investigations .....	37
C. Market Surveillance Systems.....	38
1. Exchange’s Market Monitoring Systems.....	38
2. NFA’s Market Surveillance Systems.....	39
D. Routine Surveillance of Market Fundamentals.....	40
1. Prices, Volume, and Open Interest .....	40
2. Deliverable Supply.....	41

E.	Monitoring of Large Traders and Position Levels .....	41
1.	Monitoring of Large Traders .....	41
2.	Monitoring of Position Accountability Levels .....	43
3.	Monitoring of Position Limits .....	45
4.	Exemptions from Position Limits .....	46
F.	Surveillance of Expiring Contracts .....	48
G.	Monitoring of EFRP Transactions .....	49
1.	Overview of ELX's EFRPs.....	49
2.	NFA's Monitoring and Review of EFRPs .....	51
3.	EFRP Inquiries and Investigations.....	54

## I. INTRODUCTION

The Division of Market Oversight (“Division”) has completed a rule enforcement review of the market surveillance program at ELX Futures, L.P. (“ELX” or the “Exchange”). The review covered the period from June 1, 2011 through May 31, 2012 (“target period”).<sup>1</sup> Due to the passage of the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd–Frank Act”),<sup>2</sup> which became effective during the target period, the Division examined the Exchange’s compliance with core principles related to market surveillance under Section 5(d) of the Commodity Exchange Act (“CEA”), and Core Principles 4 and 5, pre- and post-Dodd–Frank Act. Although the Dodd–Frank Act amended both Core Principles 4 and 5, the Division notes that its recommendations would have been the same whether it evaluated the Exchange’s compliance program under the old or revised core principles for the entire target period.

### **Pre-Amendment of the CEA by the Dodd–Frank Act**

#### **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.**

---

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

<sup>2</sup> The Dodd–Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010) became effective on July 16, 2011.

## Post-Amendment by the Dodd–Frank Act

### **Core Principle 4 – Prevention of Market Disruption:**

**The board of trade shall have the capacity and responsibility to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process through market surveillance, compliance, and enforcement practices and procedures, including—**

- (A) methods for conducting real-time monitoring of trading; and**
- (B) comprehensive and accurate trade reconstructions.**

### **Core Principle 5 – Position Limitations or Accountability:**

- (A) In General: To reduce the potential threat of market manipulation or congestion (especially during trading in the delivery month), the board of trade shall adopt for each contract of the board of trade, as is necessary and appropriate, position limitations or position accountability for speculators.**
- (B) Maximum Allowable Position Limitation: For any contract that is subject to a position limitation established by the Commission pursuant to section 4a(a), the board of trade shall set the position limitation of the board of trade at a level not higher than the position limitation established by the Commission.**

During the entirety of the target period, the acceptable practices set forth in Appendix B to Part 38 of the Commission’s regulations provided that an acceptable market surveillance program should regularly collect and evaluate market data, including the positions and trading of its market participants, to determine appropriate regulatory responses to potential market disruptions or abusive practices.<sup>3</sup> The program should include collecting fundamental data about the underlying commodity to determine whether market prices are responding to the forces of

---

<sup>3</sup> On May 10, 2012, the Commission issued its final rules, *Core Principles and Other Requirements for Designated Contract Markets*, 77 Fed. Reg. 36612 (June 19, 2012) (the “Final Rules”), which became effective after the target period, on October 17, 2012. Among other changes, the Final Rules revised the guidance and acceptable practices for some core principles, and for several core principles, including Core Principles 4 and 5, codified rules in lieu of guidance and acceptable practices. See 77 Fed. Reg. 36,612; 36,614; 36,702–03. Because the Final Rules were not effective during the target period, the Division evaluated the Exchange’s market surveillance program under the pre-existing guidance and acceptable practices in Appendix B to Part 38 of the Commission’s regulations.

supply and demand. In addition, the program should include an automated large trader reporting system if an exchange has a substantial number of traders trading through intermediaries.

To facilitate the orderly liquidation of expiring contracts and reduce the potential threat of problems arising from excessively large positions, an exchange may need to establish position limits for certain commodities, unless the threat of excessive speculation or manipulation is nonexistent or very low. An exchange can set position limits differently by markets, delivery months, or time periods. An exchange's position limit rules may provide for hedge or other exemptions from the limits, and the exchange should monitor the continuing appropriateness of approved exemptions. An exchange may provide for position accountability provisions in lieu of position limits for markets with large open-interest, high daily trading volumes, and liquid cash markets, including contracts based on certain financial instruments. An exchange should adopt spot-month limits for markets based on commodities that have more limited deliverable supplies, or where necessary to minimize a market's susceptibility to manipulation or price distortion. Finally, an exchange should have an effective program for enforcement of position limits, and specific policies for taking regulatory action when a violation of a position or exemption limit is detected, regardless of whether the violation is by a member or non-member.

## **II. METHODOLOGY**

The National Futures Association ("NFA") provides regulatory services to ELX, including trade practice and market surveillance, and related investigatory work. Accordingly, to assess the Exchange's compliance with Core Principles 4 and 5, Division staff interviewed compliance officials and staff from NFA's DCM Market Regulation group ("NFA" or "DCM Group") and ELX's Compliance Department ("Compliance Department"), viewed demonstrations of NFA's and ELX's automated systems and reports, and reviewed numerous

documents produced by NFA and Compliance Department staff. Documents reviewed by Division staff included the following:

- the Regulatory Services Agreement (“RSA”) between NFA and the Exchange;
- organizational charts and personnel bios for both NFA and the Exchange;
- NFA’s market regulation procedures manual for DCMs (the “Market Regulation Procedures”) and Webfocus System Manual;
- automated reports and alerts generated by NFA’s automated surveillance systems and other documents used for market surveillance;
- NFA’s communications to the Exchange’s market participants with respect to exceeding position accountability levels;
- the Exchange’s Rulebook (“ELX Rule” or “Rule”) during and after the target period;
- the Exchange’s surveillance manual and procedures;
- the Exchange’s trading system manuals and technology services agreement;
- automated reports and alerts generated by the Exchange that are used for real-time market monitoring;
- documents concerning trade cancellations during the target period;
- minutes of meetings of the Exchange’s Regulatory Oversight Committee (“ROC”) held during the target period and the ROC’s annual reports for the operating years ending in June 2011 and June 2012;
- records of the Exchange’s monthly meetings with NFA; and
- inquiry and investigation files, including NFA’s inquiry and investigative reports, NFA’s memoranda to close an inquiry, NFA’s inquiry/investigation log (the “case ageing report”), the Exchange’s investigation log, and the Exchange’s warning letters issued to market participants.

The Division provided ELX and NFA with an opportunity to review and comment on a draft of this report on July 31, 2013. On August 27, 2013, Division staff conducted an exit

conference with NFA and Exchange officials to discuss the report's findings and recommendations.

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

#### **A. Market Surveillance Staffing**

##### **Findings**

- The Exchange maintains a small but highly experienced staff to oversee the Exchange's surveillance and compliance programs, manage NFA as the provider of ELX's regulatory compliance services, enforce the Exchange's rules, and conduct real-time market monitoring.
- NFA's DCM Group staff members are well trained and highly experienced. The number of staff members assigned to Exchange matters was sufficient to properly conduct market surveillance and related investigations for the Exchange given the Exchange's trading volume during the target period.

##### **Recommendations**

- The Division has no recommendations in this area.

#### **B. Market Surveillance Inquiries and Investigations**

##### **Findings**

- NFA's inquiry and investigative work was typically thorough and complete, and its research and case files were well-documented, with two exceptions. First, NFA typically logs the start of an inquiry, preserves related documentation and correspondence, and closes an inquiry by writing a closing memorandum. The Division found, however, that NFA had opened and deleted an inquiry and had not logged or maintained any documentation or correspondence related to that inquiry. In addition, although an inquiry concerning the same party had been opened earlier and was still ongoing, NFA did not merge or close the latter opened inquiry into the earlier opened inquiry. Second, NFA did not include the date on which an inquiry had been elevated to an investigation in its investigative reports or the case ageing report. In addition, some investigative reports sent to the Division were missing signatures by NFA staff and were not signed in the proper order of review.
- The Division found that ELX's decision whether or not to pursue disciplinary action against a market participant was typically appropriate. However, the Division found that in only one investigation did the Exchange send NFA a written explanation concerning its reasons behind issuing the warning letter as opposed to pursuing disciplinary action, as required by the RSA and ELX's rules.



- NFA and ELX maintain detailed logs or reports tracking inquiries and/or investigations. These logs and reports use differing or inconsistent dates, however, that make it more difficult to evaluate the process and timing of inquiries/investigations or track an inquiry/investigation from its opening to its final disposition by the Exchange.
- NFA and the Exchange closed inquiries and investigations in a timely manner and all inquiries and investigations were closed by NFA and the Exchange within approximately 10 months or less.

### **Recommendations**

- Any inquiry or investigation initiated by NFA, even if NFA later determines not to proceed with it, should be documented, logged on the case ageing report, closed with a written closing memorandum, and retained by NFA in the same manner as any other inquiry or investigation NFA conducts and administratively closes, including all correspondence with the investigated party.
- NFA should clearly indicate in its records (e.g., inquiry/investigative reports and the case ageing report) if an inquiry or investigation is opened, and then merged or closed into an earlier opened inquiry or investigation.
- NFA should ensure that all investigative reports contain signatures by the appropriate personnel in the proper order of review, and that the reports include the date(s) of when each reviewer signed off on the report.
- NFA should include the date on which an inquiry is elevated to an investigation in all of its investigative reports and the case ageing report, if applicable, whether an inquiry was elevated to an investigation by NFA or the Exchange.
- The Exchange should prepare a written memorandum and submit it to NFA for any investigation referred by NFA and not forwarded to a disciplinary panel, including information sufficient to explain the reasons for the final action (i.e., issuing guidance or a warning letter) or non-action taken. The memoranda should also include an explanation to the extent that the Exchange issues a warning letter that differs from the potential rule violation(s) cited by NFA in the investigative report.
- The date NFA uses in its case ageing log to indicate that it has opened an inquiry should be the date it first contacts a market participant for information, or NFA should provide the Exchange with another means of accounting for the time spent by NFA prior to the “open date.”
- The Exchange’s investigation log should note the date of the initial trade or activity that led NFA to open the inquiry.

## **C. Market Surveillance Systems**

### **Findings**

- The Exchange uses automated alerts and tools to view intra-day positions in real-time to conduct real-time market monitoring.
- NFA's principal tool for monitoring trading is Webfocus. Webfocus produces automated alerts to notify staff of activity or circumstances that may require following up, and screens or reports that staff can use to analyze specific activity.

### **Recommendations**

- The Division has no recommendations in this area.

## **D. Routine Surveillance of Market Fundamentals**

### **Findings**

- NFA conducts a daily review of market news, the positions of large traders, pricing, volume, and open interest information, and reviews any automated alerts concerning open interest or price changes.

### **Recommendations**

- The Division has no recommendations in this area.

## **E. Monitoring of Large Traders and Position Levels**

### **Findings**

- NFA staff reviews and analyzes large trader reports, as well as any generated automated alerts, on a next-day ("T+1") basis. During the target period, NFA opened one inquiry based on its daily review of open interest and large trader data for a firm's failure to timely and properly submit large trader information for a reportable account. The inquiry was elevated to an investigation and referred to the Exchange, which issued a warning letter.
- NFA staff reviews the size of participants' positions via position accountability levels and to enforce speculative position limits. When a position accountability level is triggered, NFA notifies the participant and the Exchange, and the Exchange reviews the position and determines whether it is necessary to take further action. The Division found that the Exchange does not maintain any written documentation or log regarding its review of the notices from NFA and assessment of whether the positions warrant any further action by NFA or the Exchange.

- None of the Exchange’s market participants reached or exceeded a position limit. Accordingly, the Division was unable to review an Exchange response to a market participant reaching or exceeding a position limit.
- The Exchange allows market participants to apply for hedge, arbitrage, or spread transaction exemptions. None of the Exchange’s market participants have applied for an exemption since the Exchange was designated. Accordingly, the Division was unable to review applications for exemptions or the Exchange’s process for reviewing and granting exemptions.

### **Recommendations**

- The Exchange should maintain a log documenting its review and assessment of notices from NFA to market participants who have reached or exceeded a position accountability level.

## **F. Surveillance of Expiring Contracts**

### **Findings**

- NFA heightens surveillance of expiring contracts in order to detect and prevent price manipulations and facilitate orderly liquidations. Staff conducts a review of the trading and positions of large traders in light of the current state of open interest and the size and ownership of deliverable supply, monitors cash prices, and analyzes whether the basis relationship indicates any potential liquidation issues. In addition, the Exchange reviews positions in the days leading up to the spot date. During the target period, neither NFA nor the Exchange identified any problematic expirations.

### **Recommendations**

- The Division has no recommendations in this area.

## **G. Monitoring of EFRP Transactions**

### **Findings**

- ELX’s rules allow for Exchange for Physical Transactions, Exchange for Swap Transactions, Exchange of Futures for Risk Transactions, and Exchange of Futures for Futures Transactions (collectively, “EFRPs” or “EFRP transactions”).
- NFA conducts a continuous cursory review of all transactions identified as EFRPs in the Exchange’s audit trail data on a T+1 basis. This review includes a review of the pricing, quantity, timing, and firm/accounts involved in the transaction. In addition to this review process, on a monthly basis, NFA will randomly select an EFRP transaction(s) to review in more depth to verify if the EFRP transaction is bona fide and in compliance with Exchange rules. The Exchange decided not to include basis trades that were

electronically matched as Exchange for Physical Transactions by a third party system (“matched EFRPs”) in the monthly review process because they were electronically matched and included in NFA’s continuous cursory review.

- The Division believes that NFA should have a more robust process for reviewing more EFRP transactions to verify that the transactions are bona fide and the parties to an EFRP transaction maintain relevant documents. In addition, while the Division believes that NFA may utilize a degree of randomization in selecting EFRPs for verification, NFA should also review more EFRP transactions with an eye to detecting potentially violative transactions.
- NFA closed one EFRP inquiry administratively and elevated two EFRP inquiries to investigations and referred them to ELX. ELX closed the two investigations by issuing warning letters. ELX also issued a warning letter in connection with an EFRP investigation that NFA had closed prior to the target period.

### **Recommendations**

- Matched EFRPs should be included in the existing pool of transactions subject to random review.
- Although NFA may utilize a degree of randomization in selecting EFRPs for verification, NFA should strategically select more EFRP transactions for review with an eye to detecting misconduct.
- NFA ensure that it reviews EFRP transactions from every Clearing Privilege Holder that clears EFRPs on the Exchange every calendar year.

## **IV. ELX OPERATIONS**

### **A. ELX Designation as a Contract Market**

ELX was formed in December 2007 by a group of 12 investment banks, trading firms, and technology providers. On May 22, 2009, the Commission approved ELX's designation application as a DCM under the CEA and the Commission's regulations.<sup>4</sup>

On July 10, 2009, ELX completed its first day of trading. ELX listed four U.S. Treasury products for trading: Short Term (Two-Year) U.S. Treasury Note futures; Medium Term (Five-Year) U.S. Treasury Note futures; Long Term (6½ to 10-Year) U.S. Treasury Note futures; and U.S. Treasury Bond futures; and on January 11, 2010, it launched the Ultra Long-Term U.S. Treasury Bond futures (collectively, the "U.S. Treasury futures"). On June 18, 2010, it listed an additional interest rate product, the Three-Month Eurodollar futures (collectively with the U.S. Treasury futures, the "Interest Rate futures").

ELX uses eSpeed for its electronic trading platform (the "ELX System"), which is provided and maintained by BGC Partners, Inc. ("BGC"). The Exchange does not have equity or membership requirements, and allows direct market access to the ELX System (i.e., Exchange trading privileges) to approved FCMs or self-clearing firms ("ELX Participants"), employees of a registered Participant ("Authorized Traders"), and non-FCMs or firms that do not self-clear ("Authorized Customers") (collectively, "market participants" or "participants").<sup>5</sup> Clearing services are provided by the Options Clearing Corporation ("OCC" or the "Clearinghouse").

---

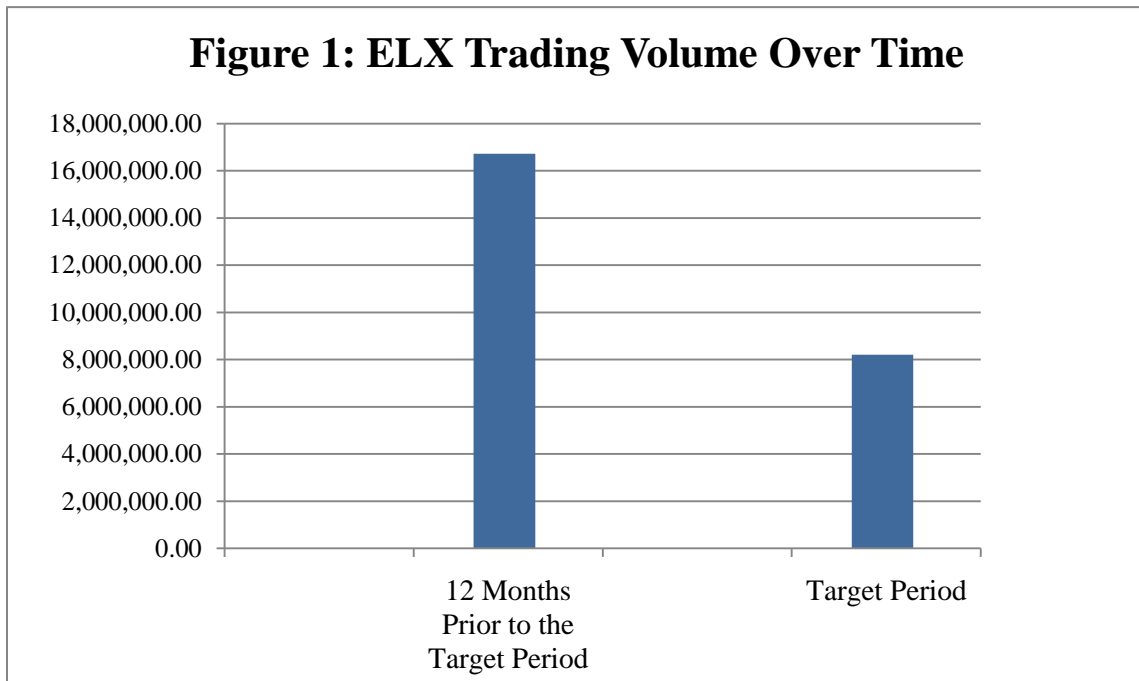
<sup>4</sup> See CFTC, Division of Market Oversight, *Order of Designation as a Contract Market* (May 22, 2009), available at <http://www.cftc.gov/ucm/groups/public/@rulesandproducts/documents/ifdocs/elx052209.pdf>; CFTC, Division of Market Oversight, *Designation Memorandum* (May 18, 2009), available at <http://www.cftc.gov/ucm/groups/public/@rulesandproducts/documents/ifdocs/elx051809.pdf>.

<sup>5</sup> Applications for trading privileges for Authorized Customers must (i) be authorized by an ELX Participant; and (ii) guaranteed by a member of the OCC ("Clearing Privilege Holder"). See ELX Rule III-7(d); see also ELX Rule III-13.

**B. Products and Trading Volume During the Target Period**

During the target period, 8,211,012 contracts were traded on the Exchange. Volume ranged from a high of 1,770,092 contracts in June 2011 to a low of 30,861 contracts in May 2012. The Exchange’s volume included 116 EFRP transactions that were executed outside of the ELX System and then brought to the Exchange for clearing, which accounted for 2,891 contracts of the Exchange’s total volume during the target period. There were no block trades during the target period.

Figure 1 below shows the total Exchange volume during the target period and the 12 months prior to the target period.<sup>6</sup> As indicated below, the Exchange experienced a decrease in volume (from a total volume of 16,725,433 contracts to 8,211,012 contracts) during the target period (June 1, 2011 through May 31, 2012), as compared to the year prior to the target period (June 1, 2010 through May 31, 2011).



<sup>6</sup> Data in this section was obtained from the Exchange.

During the target period, the Exchange offered the six Interest Rate futures, and on May 14, 2012, introduced five agricultural futures contracts: Corn, Wheat, Soybean, Soybean Meal, and Soybean Oil (collectively, the “Agricultural futures”). After the target period, on September 10, 2012, ELX added five two percent coupon U.S. Treasury futures contracts: Two Percent Short Term (Two-Year) Note, Two Percent Medium Term (Five-Year) Note, Two Percent Long Term (10-Year) Note, Two Percent Bond, and Two Percent Ultra Long-Term Bond (collectively, the “Coupon futures”). The Exchange does not list or trade options.

Figure 2 below lists the names (ranked by trading volume) and total trading volumes for the contracts active on the Exchange during the target period. Trading in U.S. Treasury Bond futures and Three-Month Eurodollar futures represented more than half (56 percent) of total Exchange volume during the target period.<sup>7</sup> As of the date of this report, there has been no trading volume in the Agricultural futures or Coupon futures.

<b>Figure 2: ELX Trading Volume By Contract During the Target Period</b>			
<b>Futures Product</b>	<b>Volume (in contracts)</b>	<b>Off-Exchange Volume (in EFRP contracts)</b>	<b>Percentage of Total Exchange Volume</b>
<b>U.S. Treasury Bond Futures</b>	<b>2,514,622</b>	<b>1,382</b>	<b>31%</b>
<b>Three-Month Eurodollar Futures</b>	<b>2,035,459</b>	<b>0</b>	<b>25%</b>
<b>Medium Term (Five-Year) U.S. Treasury Note Futures</b>	<b>1,576,661</b>	<b>192</b>	<b>19%</b>
<b>Long Term (6½ to 10-Year) U.S. Treasury Note Futures</b>	<b>1,378,706</b>	<b>1,317</b>	<b>17%</b>
<b>Short Term (Two-Year) U.S. Treasury Note Futures</b>	<b>607,963</b>	<b>0</b>	<b>7%</b>
<b>Ultra Long-Term U.S. Treasury Bond Futures</b>	<b>97,601</b>	<b>0</b>	<b>1%</b>

<sup>7</sup> Data in Figure 2 was obtained from the Exchange.

Although U.S. Treasury Bond futures and Three-Month Eurodollar futures accounted for the majority of ELX's volume during the target period, ELX's share of these futures markets in the United States is relatively small. ELX accounted for approximately .06 percent of U.S. Treasury Bond futures trading volume during the last month of the target period, while NYSE Liffe U.S. ("NYSE Liffe") accounted for approximately .26 percent and the Chicago Board of Trade ("CBOT") accounted for approximately 99.68 percent.<sup>8</sup> With respect to Three-Month Eurodollar futures trading volume, during the last month of the target period ELX accounted for approximately .03 percent, NYSE Liffe accounted for approximately 1.81 percent, and the Chicago Mercantile Exchange ("CME") accounted for approximately 98.17 percent.<sup>9</sup>

### **C. ELX Governance**

#### **1. ELX Ownership and Board of Directors**

ELX Futures Holdings, LLC ("Holdings") is a Delaware limited liability company and the sole general partner of ELX. ELX is primarily (99.75 percent) owned by the individual members of Holdings, in the form of limited partnership interests. The remaining 0.25 percent of the equity interests in ELX is owned indirectly by the members through Holdings, in the form of a general partnership interest. In March 2012, the members of Holdings approved an arrangement by which founding members gave up a portion of their ownership stakes in Holdings to BGC, making BGC the controlling owner of Holdings. Nine of the 13 founding members hold the remaining partnership interests in Holdings.

The Exchange is governed by a management board (the "Management Board") and a supervisory board (the "Supervisory Board") (collectively, the "Governing Boards"). The

---

<sup>8</sup> This data was obtained from the Exchange and Commission trading volume statistics. Individual values are rounded to the nearest hundredth and may not total 100 percent.

<sup>9</sup> See *supra* note 8.



Supervisory Board consists of directors appointed by the members of Holdings, commensurate with the class and amount of ownership units held. The Management Board includes all of the Supervisory Board's directors, plus a sufficient number of public directors appointed by the members of Holdings to ensure that the Exchange meets the Commission's guidance on exchange board composition (i.e., at least thirty-five percent public directors).<sup>10</sup> All members of the Governing Boards must meet fitness standards and, if relevant, the definition of public directors. As of the March 2012 reorganization of Holdings, the Supervisory Board consists of 12 directors, and the Management Board consists of 19 directors, including seven directors who qualify as public directors (approximately 37 percent of the total number of Management Board directors).

The Management Board manages the Exchange, and appoints and oversees the Exchange's ROC. The Supervisory Board reviews and approves the Management Board's actions, with the exception of the actions of the ROC and any actions the Management Board takes in connection with its oversight of the ROC. Regulatory costs to be incurred at the discretion of the ROC, however, are subject to review by the Supervisory Board to ensure their reasonableness. The Supervisory Board has never disapproved or reduced regulatory costs that the ROC has approved.

## 2. Regulatory Oversight Committee

The ROC, which is a committee of the Management Board made up of public directors appointed by the Management Board, oversees the Exchange's self-regulatory program. Each

---

<sup>10</sup> During the target period, the applicable acceptable practices for Core Principle 15 of the CEA stated that "[a]t least thirty-five percent of the directors on a contract market's board of directors shall be public directors." Core Principle 15 was re-designated as Core Principle 16 by the Dodd-Frank Act. The Final Rules adopted the acceptable practices for pre-Dodd-Frank Act Core Principle 15 as acceptable practices for the post-Dodd-Frank Act Core Principle 16. The Division notes that this review does not contain any judgments with respect to the Exchange's compliance with the pre-Dodd-Frank Act Core Principle 15 or the post-Dodd-Frank Act Core Principle 16.

member of the ROC serves a term of two calendar years from the date of his or her appointment, or for the remainder of the term to which he or she is appointed until the appointment of his or her successor. A ROC member may resign before the two-year term ends or be removed (as a member of the ROC or as a member of the Management Board) for cause. At the beginning of the target period the ROC had four members; however, later during the target period the ROC was reduced to three members.<sup>11</sup>

The ROC's duties are to oversee the Exchange's regulatory program on behalf of the Management Board and make such recommendations to the Management Board as will, in its judgment, best promote the interests of the Exchange.<sup>12</sup> As part of its responsibilities, the ROC supervises the Exchange's Senior Vice President and Compliance Director (the "Compliance Director"), reviews the regulatory budget and staffing, and must annually prepare a report that evaluates the effectiveness of the Exchange's self-regulatory program. The Compliance Director and ROC were satisfied that the Exchange's budget provided for sufficient compliance resources and staffing during the target period and on a prospective basis.

---

<sup>11</sup> One of the members of the ROC resigned on his own accord in March 2012 from the ROC and the Management Board.

<sup>12</sup> See ELX Rule II-5. Rule II-5 also includes a more detailed list of responsibilities, which states that the ROC shall have authority to: (i) monitor the Exchange's regulatory program for sufficiency, effectiveness and independence, (ii) oversee all facets of the Exchange's regulatory program, including trade practice and market surveillance; audits, examinations, and other regulatory responsibilities with respect to Participants and their Authorized Traders, other Supervised Persons and Authorized Customers (including ensuring compliance with any financial integrity, financial reporting, sales practice, recordkeeping, and other requirements); and the conduct of investigations and review of disciplinary actions, (iii) review the size and allocation of the regulatory budget and resources; and the number, hiring and termination, and compensation of regulatory personnel, (iv) supervise the Compliance Director, (v) prepare an annual report assessing the Exchange's self-regulatory program for the Board and the CFTC, which sets forth the regulatory program's expenses, describes its staffing and structure, catalogues disciplinary actions taken during the year, and reviews the performance of disciplinary committees and panels, (vi) recommend changes that would ensure fair, vigorous, and effective regulation, (vii) review regulatory proposals, as well as any proposals or actions of the Market Practices Committee, and advise the Board as to whether and how such proposals or actions changes may impact regulation, and (viii) exercise any other functions expressly assigned to it in these Rules.

Although the Exchange does not have a charter or formal requirement regarding how often the ROC meets, the ROC generally meets three to four times a year to discuss regulatory compliance, proposed rule changes, and to summarize the status of any pending investigations and disciplinary matters. During the target period, the ROC met three times, and the Compliance Director and ROC conferred informally on a more regular basis.

## **V. MARKET SURVEILLANCE PROGRAM**

### **A. Market Surveillance Staffing**

#### **1. ELX Compliance Department Staff and Responsibilities**

ELX's Compliance Department consists of two staff members, the Compliance Director and the Deputy Compliance Director. The Compliance Director and Deputy Compliance Director have a combined 35 years of experience in the industry, and 23 years of experience in compliance and with the CEA and Commission regulations. The Compliance Director's responsibilities include overseeing the Exchange's surveillance and compliance programs, managing NFA as the provider of ELX's regulatory compliance services, and enforcing the Exchange's rules.<sup>13</sup> The Compliance Director reports directly to the ROC; but for administrative matters, the Compliance Director reports to ELX's Chief Executive Officer ("CEO"). The Compliance Director is the direct supervisor of the Deputy Compliance Director, and shares supervision of the control desk that conducts ELX's real-time market monitoring (the "Control Desk"), with the CEO. The Deputy Compliance Director assists the Compliance Director with his responsibilities, and is also responsible for conducting reviews and examinations associated with the Exchange's financial and audit trail surveillance programs. The Compliance Director's

---

<sup>13</sup> As discussed in more detail *infra* Sections V.C.1 and V.F, the Compliance Director also conducts some aspects of market surveillance that NFA is not responsible for, including conducting real-time market surveillance by reviewing ELX's alerts and real-time monitors, and contacting market participants with respect to contract expiration and deliveries.

and Deputy Compliance Director's compensation and employment tenure are determined by the ROC.

The Control Desk conducts ELX's market operations, real-time market monitoring, and customer support,<sup>14</sup> and reports to the Compliance Director and CEO. During the target period, the Control Desk consisted of three shift supervisors and a Vice President responsible for managing the Control Desk, and Control Desk personnel had a median tenure of 33 years of industry experience.<sup>15</sup> The procedures the Control Desk follows to conduct its responsibilities are detailed in ELX's Market Supervision Policies and Procedures manual.

The Exchange does not have a mandatory continuing education requirement for Compliance Department personnel. However, members of the Compliance Department review industry publications and attend industry conferences and Joint Compliance Committee ("JCC") meetings to keep informed on regulatory matters.<sup>16</sup> Compliance Department personnel also attend the Exchange's weekly staff-wide status meetings and weekly Control Desk meetings, and any issues that need regulatory attention can be raised with the Compliance Director or the Deputy Compliance Director at those meetings.

---

<sup>14</sup> In addition, the Control Desk has the authority to halt the ELX System, implied engine, or specific contract(s) in order to prevent imminent customer or market harm as a result of technological issues. The Control Desk also has the authority to suspend user connections for publishing excessive trade requests, erroneous prices or quantities, or repeated improperly formatted requests. In the event of a halt or user suspension, activity can only be resumed at the direction of the CEO or the Compliance Director (together, "ELX Management"). Any other conditions that might be disruptive to the market and warrant a halt or suspension are considered emergencies and must be escalated to ELX Management. Rule IV-20 provides ELX's process for responding to and handling emergencies.

<sup>15</sup> BGC personnel also advise the Control Desk with respect to any technical issues concerning ELX's trading platform; however, pursuant to the Market Supervision Policies and Procedures, only ELX personnel can make decisions regarding actions to be taken by the Control Desk.

<sup>16</sup> The JCC was formed in May 1989 with the purpose of fostering improvements and uniformity in the systems and procedures used by DCMs for regulatory compliance. It is comprised of senior compliance officials from DCMs and the NFA in its capacity as regulatory service provider to several DCMs. The JCC typically meets in-person twice a year and schedules additional meetings via telephone as needed.

The Division believes that the number of Exchange personnel was sufficient for market surveillance purposes during the target period.

2. NFA Compliance Staff and Coordination with ELX

NFA's Market Regulation Group ("Market Regulation") handles NFA regulatory compliance.<sup>17</sup> Market Regulation consists of the DCM Group, the SEF Market Regulation group ("SEF Group"), and the Forex Market Regulation group ("Forex Group"). The DCM Group has a vertical structure and consists of five analysts/senior analysts, two managers, one senior manager, and the Associate Director of the DCM group ("Associate Director").<sup>18</sup> The Vice President of Market Regulation oversees the Associate Director. The Associate Director, managers, and senior managers of the DCM Group have a median tenure of 24 years of industry experience. In addition, two SEF Group employees are cross-trained to work with the DCM Group, if the DCM Group needs additional resources. During the target period, the DCM Group conducted trade practice and market surveillance for five exchanges, including ELX. Among exchanges utilizing the DCM Group for regulatory services during the target period, ELX was the third largest exchange by volume.<sup>19</sup>

---

<sup>17</sup> Market Regulation was formerly known as the Trade Practice and Market Surveillance group ("TPMS"). The Division previously reviewed TPMS in its April 20, 2012 report for the rule enforcement review of NYSE Liffe's trade practice surveillance program for the November 1, 2009 through November 1, 2010 target period ("2012 NYSE Liffe Review"), available at <http://www.cftc.gov/ucm/groups/public/@iodcms/documents/file/remyseliffe042012.pdf>. Because the report for the 2012 NYSE Liffe Review was published towards the end of ELX's target period, NFA was either not on notice of, or able to implement, recommendations made in that report during ELX's target period.

<sup>18</sup> During the target period for the 2012 NYSE Liffe Review, Market Regulation staff consisted of eight individuals, including the Associate Director, who worked full-time on DCM compliance. In the report for the 2012 NYSE Liffe Review, the Division recommended that "NFA and [NYSE Liffe] undertake a comprehensive review of NFA staff and NYSE Liffe resources to determine whether such resources were sufficient for NYSE Liffe's volume levels." 2012 NYSE Liffe Review at 21. Subsequent to the target period for that review, Market Regulation added another senior analyst, bringing the total number of staff, including the Associate Director, working full-time on DCM compliance to nine individuals.

<sup>19</sup> During the target period, the DCM Group provided similar services to CBOE Futures Exchange, LLC ("CFE"); Eris Exchange, LLC ("Eris Exchange"); Nasdaq OMX Futures Exchange, Inc. ("NFX"); and NYSE Liffe. Trading volume data for CFE and NYSE Liffe was obtained from Futures Industry Association monthly volume and open

NFA's market surveillance responsibilities are detailed in the RSA.<sup>20</sup> With respect to market surveillance, the RSA provides that NFA will use an automated system to monitor market prices, volume, open interest, the basis relationship between the Exchange product and the corresponding cash market, and concentrations of large positions. It also provides that NFA will analyze expirations and deliveries, and monitor for compliance with position accountability levels and position limits. Pursuant to the RSA, NFA is also primarily responsible for performing the investigatory work relating to inquiries and investigations.<sup>21</sup> In addition to these services in the RSA, NFA also prepares a checklist (the "Delivery Checklist") for ELX, which tracks and analyzes contract expirations and open interest.

New Market Regulation employees receive four to eight weeks of training, depending on their level of previous experience. This training includes a formal training program called the "Step Program," where the new employee learns about NFA's procedures and automated systems, and how to review and analyze NFA's trade practice and market surveillance reports and alerts. New staff also spend time observing an analyst or senior analyst while they are conducting trade practice and market surveillance analysis. In addition, NFA cross-trains analysts so that they are familiar with the rules of each exchange for which the DCM Group provides regulatory services.

---

interest reports. Trading volume data for Eris Exchange and NFX was obtained from Commission trading volume statistics. Because Eris Exchange was designated as a DCM during the target period on October 28, 2011, the data used for Eris Exchange is from when Eris Exchange commenced trading in late 2011 through the end of the target period.

<sup>20</sup> The RSA in effect during the target period was executed in April 2009. The RSA was revised subsequent to the target period; however, the revisions do not substantively affect the findings and recommendations in this report.

<sup>21</sup> Although the language of the RSA provides that NFA is "primarily" responsible for performing most of the investigatory work relating to inquiries and investigations; in practice, NFA conducts the investigatory work unless a member of the Compliance Department becomes more involved in fact-finding and communicating with the investigated party. NFA is kept informed in matters where a member of the Compliance Department conducts investigatory work and communicates with the investigated party.

There is no formal continuing education requirement for Market Regulation staff, but staff stays informed through monthly Market Regulation meetings and bi-monthly training meetings led by DCM Group staff members with specific knowledge or expertise. NFA has also implemented a policy to provide additional opportunities for outside training. Finally, Market Regulation staff is encouraged to enhance their market knowledge through reading industry publications, the Commission's website, and online market news sources.

Each exchange for which NFA provides regulatory services is assigned a lead analyst, as well as one or two back-up analysts.<sup>22</sup> Analysts assigned to an exchange review the exchange's rules and contracts, review the RSA with the exchange, and utilize the exchange's real-time screens to observe trading and pricing in order to become familiar with the exchange. While each lead analyst typically conducts trade practice and market surveillance for the exchange they are assigned, on any given day any one of the other analysts, senior analysts, or managers could be called upon to conduct trade practice or market surveillance for that exchange if the lead analyst is out of the office or has other work to complete. On a typical day, a manager and senior manager will review the analyst's work, or a manager will perform the work and a senior manager will review the manager's work. Given ELX's trading volume during the target period, the lead analyst for ELX did not work full-time on trade practice and market surveillance for the Exchange. Time spent by the rest of the DCM Group on ELX matters varied, but was also a relatively small amount.

The DCM Group interacts regularly with ELX's Compliance Department to keep it informed of any issues related to the regulatory services provided. As required by the RSA, each

---

<sup>22</sup> The assignments are reviewed at least every six months for possible rotation based on staff development needs, exchange volume and workload, and the addition of new exchanges. The exchange lead analyst can also communicate with the managers/senior manager for additional resources, if necessary.

month, the DCM Group sends ELX two reports. One report includes all trade practice exceptions generated by the number and type of exception.<sup>23</sup> The second report is a log (the “case ageing report”), which includes trade practice and market surveillance inquiries and investigations that are open on behalf of ELX and the nature of the alleged violations. The DCM Group also conducts regular monthly meetings with ELX’s Compliance Department to discuss outstanding inquiries/investigations, compliance issues raised by either party, new market makers, changes to existing incentive programs or new incentive programs, new Exchange business (e.g., contract launches), as well as any other items of note. When circumstances warrant, the DCM Group and ELX’s Compliance Department communicate more frequently via email or telephone. In addition, the Compliance Director is copied on all of the DCM Group’s emails to ELX’s market participants.

The Division believes that the number of DCM staff was sufficient for ELX’s market surveillance purposes during the target period.

## **B. Market Surveillance Inquiries and Investigations**

### **1. Overview of Market Surveillance Inquiries and Investigations**

As part of its RSA with ELX, NFA is primarily responsible for conducting trade practice and market surveillance inquiries and investigations on behalf of ELX.<sup>24</sup> When NFA opens a case it starts out as an inquiry. An inquiry can be initiated from either proactive or reactive sources. Proactive sources of market surveillance inquiries include staff review of reports or automated alerts generated by Webfocus, review of off-Exchange transactions, and overall

---

<sup>23</sup> NFA’s automated trade practice surveillance system generates trade practice exception reports when trading behavior exhibits suspicious patterns or breaches pre-programmed parameters. Trade practice exceptions identify potentially violative conduct and alert NFA staff to matters that require further review. Market surveillance-related automated alerts, discussed *infra* Sections V.C.2 and V.E, do not indicate potentially violative conduct, and are used by NFA to identify situations that may need to be examined further.

<sup>24</sup> See *supra* text accompanying note 21.



market surveillance.<sup>25</sup> In addition, staff conducts a monthly review of a randomly selected off-Exchange EFRP or block trade transaction, which becomes the source of an inquiry.<sup>26</sup> Reactive sources of market surveillance inquiries include customer complaints or referrals from the Exchange or other regulatory body.

The RSA between ELX and NFA provides that if NFA believes that an inquiry should become an investigation, NFA staff is to contact the Compliance Director to explain the results of its inquiry and make a recommendation to open an investigation. The Compliance Director will then make a determination as to whether an investigation is necessary. If the Compliance Director declines to follow NFA's recommendation to elevate an inquiry to an investigation, the RSA requires that the Compliance Director notify NFA in writing and provide an explanation for the decision.

In practice, however, the transition from inquiry to investigation is less formal than as described in the RSA. If, through the course of the fact gathering process and staff analysis, NFA determines that there is not a high probability of the activity violating Exchange rules, NFA closes the inquiry administratively and prepares a memorandum to close. In instances where NFA believes the inquiry should be elevated to an investigation, NFA staff does not contact the Compliance Director for a determination as to whether further investigation is necessary. Instead, NFA elevates the inquiry to an investigation. By elevating an inquiry to an investigation, NFA can expand its review by requesting additional documentation from market participants and conducting formal interviews. Only a manager or a more senior employee can elevate an inquiry to an investigation.

---

<sup>25</sup> NFA's market surveillance program is discussed in more detail *infra* Sections V.C – G.

<sup>26</sup> NFA's review of EFRP transactions is discussed in more detail *infra* Section V.G.

At the conclusion of an investigation, NFA prepares a written investigative report, which includes an investigative summary, supporting documentation and correspondence, a summary of the investigated party's disciplinary history with the Exchange, and a recommendation. NFA's recommendation does not recommend a specific disciplinary action to the Exchange; rather, NFA recommends that the Exchange review the activity for compliance with specifically enumerated Exchange rules. NFA's investigative report is reviewed and signed by an analyst, a manager/senior manager, and the Associate Director before it is sent to the Exchange and the investigation is closed. The Compliance Director reviews each investigative report to determine whether a reasonable basis exists to believe that a violation within the Exchange's jurisdiction has occurred or is about to occur, and closes the case by closing the investigation with no action, disposing of the investigation through a warning letter or guidance, or initiating disciplinary proceedings.<sup>27</sup>

NFA uses its Financial Analysis and Audit Compliance Tracking System ("FACTS 2000") to track the opening and closing of Market Regulation inquiries and investigations.<sup>28</sup> When a Market Regulation inquiry is opened in FACTS 2000, it is given a unique case number that includes the current year, a system-generated five-digit number, and the designation "MINV," which differentiates Market Regulation inquiries from other inquiries. When an inquiry is elevated to an investigation, the inquiry is closed into an investigation on FACTS 2000, and retains the same case number. Only a senior manager or Associate Director can close an inquiry or investigation in FACTS 2000. Once an investigation is opened, staff includes relevant information on the investigation's status in a spreadsheet (the "case status update"),

---

<sup>27</sup> See ELX Rule VII-5.

<sup>28</sup> FACTS 2000 is NFA's mainframe database for financial data, audit, and other compliance information about NFA member firms.

which is updated at each stage of the investigation process and maintained on NFA's Market Regulation Portal website (the "Portal").

2. Adequacy of Inquiries and Investigations

a. *Inquiries and Investigations Reviewed by the Division*

In connection with this rule enforcement review, Division staff reviewed the files for all four market surveillance cases closed by NFA during the target period. One case was opened as an inquiry and closed administratively by NFA, and three cases were opened as inquiries, elevated to investigations, and closed by NFA when the investigative reports were referred to the Exchange.<sup>29</sup> During the target period, the Exchange closed two of the three investigations by issuing warning letters, and the Exchange closed the third investigation by issuing a warning letter subsequent to the target period.<sup>30</sup> The Division also reviewed the files for a fifth market surveillance investigation, which NFA had closed prior to the target period and the Exchange closed during the target period by issuing a warning letter.<sup>31</sup>

---

<sup>29</sup> Case numbers 2011MINV0974 (an EFRP transaction inquiry/investigation opened before and closed during the target period); 2011MINV2393 (a large trader inquiry/investigation opened and closed during the target period); 2011MINV02786 (an EFRP transaction inquiry opened and administratively closed during the target period); and 2012MINV00412 (an EFRP transaction inquiry/investigation opened and closed during the target period). An additional inquiry that was opened by NFA during the target period, case number 2011MINV1266, is discussed *infra* in Section V.B.2.b.

<sup>30</sup> After NFA closes an investigation and it is referred to the Exchange, the Compliance Director reviews the investigative report and disposes of the investigation by (i) remitting the matter back to NFA for further investigation; (ii) forwarding the investigative report to a disciplinary panel with or without a recommendation; (iii) closing the investigation by issuing a warning letter or guidance to the investigated party; or (iv) closing the investigation with no action. *See infra* Section V.B.2.e.

Warning letters were sent by the Exchange to the investigated party during the target period for violating ELX rules in case numbers 2011MINV0974 (ELX Rule IV-16 (Exchange of Futures for Related Positions)) and 2011MINV2393 (ELX Rule IV-14 (Required Reports)), and subsequent to the target period in case number 2012MINV00412 (ELX Rules IV-16 (Exchange of Futures for Related Positions) and V-1 (Books and Records; Cooperation in Proceedings)).

<sup>31</sup> Case number 2010MINV02104 (an EFRP transaction inquiry/investigation opened and closed by NFA before the target period). The Exchange sent a warning letter to the investigated party for a violation of ELX Rules IV-16 (Exchange of Futures for Related Positions) and V-1 (Books and Records; Cooperation in Proceedings) during the target period.

b. *Inquiries Closed by NFA During the Target Period*

The Division found that the research and case files for the market surveillance inquiries it reviewed were well-documented. In addition to the inquiries reviewed by the Division, however, Division staff found a reference in the Exchange's documents to another market surveillance inquiry opened by NFA in June 2011.<sup>32</sup> NFA evidently opened the June 2011 inquiry as part of its regular review of a randomly selected EFRP transaction.<sup>33</sup> According to the Exchange's documents, the inquiry was assigned a "MINV" number by NFA, case number 2011MINV1266, and an analyst from NFA contacted the subject firm for documents regarding the EFRP transaction. The Exchange's documents also indicate that after contacting the subject firm, NFA and the Exchange discussed the inquiry, and NFA elected not to conduct the review of the EFRP transaction. NFA, however, does not have any written documentation, records, or correspondence related to case number 2011MINV1266.

When asked by the Division to explain why it did not have any record of case number 2011MINV1266, NFA indicated that if a new inquiry is opened and seems duplicative or redundant of an already ongoing inquiry, and there are no documents related to the new inquiry, the new inquiry is essentially an empty file that can be deleted from the system. If staff collects documents or conducts analysis in connection with the new inquiry before a more senior employee determines the new inquiry should be deleted, the documents and analysis are supposed to be merged into or referenced in the already ongoing inquiry in FACTS 2000. NFA explained that it deleted case number 2011MINV1266 from its system and did not proceed with that inquiry because it was already in the process of reviewing an earlier EFRP transaction by the

---

<sup>32</sup> The June 2011 inquiry was referenced in the Exchange's documentation of its regular monthly meetings with NFA.

<sup>33</sup> NFA's process for reviewing and monitoring EFRP transactions is discussed in more detail *infra* Section V.G.

same firm (in case number 2011MINV0974), and had not yet collected documents from the firm in case number 2011MINV1266.

Although the Exchange was aware that case number 2011MINV1266 was opened as an inquiry and subsequently not carried out by NFA, the Division believes it is inappropriate for NFA to ever delete an opened inquiry. Without any documentation or a closing memorandum, Division staff cannot evaluate why the inquiry was closed, whether NFA or the Exchange made the decision to close, or evaluate the decision to do so. Moreover, Division staff cannot evaluate the veracity of NFA's explanation that it merely deleted an empty file, particularly in light of the Exchange's record indicating NFA had communicated with the firm as part of the inquiry. If the firm had been contacted by NFA, the communication, and any response from the firm, should have been retained by NFA as part of the inquiry documentation.

Moreover, the Division believes that deleting a later started inquiry because it involves the same firm and/or activity could potentially lead NFA to fail to uncover repeated rule violations of the same activity and/or by the same firm. Indeed, the firm in question had previously received more than one warning letter concerning various EFRP rule violations (one before the target period, one during the target period, and one shortly after the target period),<sup>34</sup> and if NFA had proceeded with the deleted inquiry, it potentially could have found that the firm was again not in compliance with the Exchange's rules for other EFRP transactions.

Accordingly, the Division recommends:

---

<sup>34</sup> Case numbers 2009MINV2516 (warning letter sent on October 26, 2010 in connection with Rules IV-16(i) (Exchange of Futures for Related Positions – designation as EFRP on trade statements) and V-1 (Books and Records; Cooperation in Proceedings)); 2011MINV0974 (warning letter sent on September 12, 2011 in connection with Rule IV-16(h) (Exchange of Futures for Related Positions – reporting timeframe)); and 2012MINV00412 (warning letter sent on June 28, 2012 in connection with Rules IV-16(i) (Exchange of Futures for Related Positions – designation as EFRP on trade statements) and V-1 (Books and Records; Cooperation in Proceedings)). The Division notes that although the details in the Exchange's warning letters make it apparent as to which specific provision of Rule IV-16 was violated, the Division suggests that the Exchange note the specific provision in each warning letter in order to facilitate the determination of whether a later violation is of the same provision.

- **Any inquiry or investigation initiated by NFA, even if NFA later determines not to proceed with it, should be documented, logged on the case ageing report, closed with a written closing memorandum, and retained by NFA in the same manner as any other inquiry or investigation NFA conducts and administratively closes, including all correspondence with the investigated party.**
- **NFA should clearly indicate in its records (e.g., inquiry/investigative reports and the case ageing report) if an inquiry or investigation is opened, and then merged or closed into an earlier opened inquiry or investigation.**

c. *Investigations Closed by NFA During the Target Period*

The Division found that the research and case files for the market surveillance investigations it reviewed were thorough, well-documented, and complete, subject to two exceptions. First, although the Exchange received signed investigative reports from NFA, Division staff found that some of the signature pages in the reports that were sent to the Division were not signed by all of the reviewers, or were not signed in the proper order of the chain of review. There was also no indication from the signature pages of the date that a specific reviewer signed off on the investigative report.

The Division is concerned that unsigned reports and reports signed out of order could potentially give the appearance that the report was not fully reviewed before being closed. Further, undated signatures hinder transparency with respect to the timeliness with which NFA staff completes an investigation. Accordingly, the Division recommends:

- **NFA should ensure that all investigative reports contain signatures by the appropriate personnel in the proper order of review, and that the reports include the date(s) of when each reviewer signed off on the report.**

Second, Division staff noted that although FACTS 2000 records the date an inquiry was elevated to an investigation, NFA's investigative reports and case ageing report do not include the date an inquiry was elevated to an investigation. Consequently, it may be difficult for

Division staff to evaluate NFA's process for, or timeliness of, elevating an inquiry to an investigation. In addition, if the Compliance Director chooses to exercise his right in the RSA to make the determination to elevate an inquiry, the Division believes that the date on which the inquiry is elevated to an investigation (and by whom) is necessary to determine whether responsibility for any delays in processing rests with NFA or the Exchange. Accordingly, the Division recommends:

- **NFA include the date on which an inquiry is elevated to an investigation in all of its investigative reports and the case ageing report, and if applicable, whether an inquiry was elevated to an investigation by NFA or the Exchange.**

d. *Exchange Review of NFA Inquiries*

As described above (*see supra* Section V.B.1), if NFA closes an inquiry administratively with no action, it prepares a memorandum to close the inquiry. During the target period, NFA closed case number 2011MINV02786 administratively with a memorandum to close.<sup>35</sup> NFA, however, did not send the memorandum to the Exchange. Instead, the Exchange was informed by NFA during one of its regular monthly meetings with NFA that a market surveillance inquiry was opened and closed, and received a brief description of why the inquiry was closed.

Although the Division believes that NFA's memorandum to close was satisfactory and that NFA kept the Compliance Director informed, the Division believes that the Compliance Director cannot effectively evaluate whether or not NFA staff is correct in its decisions to close matters administratively if the Compliance Director does not review the final report of inquiries that do not become investigations.

---

<sup>35</sup> As discussed *supra* Section V.B.1, the RSA does not have a provision for NFA closing an inquiry administratively. The Division believes that permitting NFA to close an inquiry administratively through a memorandum to close that is then sent to the Exchange is an acceptable process, but suggests that NFA and the Exchange review the RSA to ensure that it reflects this process.

As a result of this deficiency, the Division would have recommended that NFA promptly send its memoranda to close to ELX's Compliance Director so that the Compliance Director could review the memoranda and monitor the sufficiency of NFA's inquiry process and substantive determinations. However, the Division understands that in light of a similar recommendation made in a rule enforcement review of another DCM that contracts with NFA for regulatory services, NFA has clarified in its Market Regulation Procedures that an electronic copy of the memorandum to close should be emailed to the Compliance Director upon closing the inquiry.<sup>36</sup> Accordingly, the Division has determined that NFA's procedures are adequate, and advises NFA to ensure it sends a copy of closing memoranda to the Compliance Director and that the Compliance Director promptly reviews such memoranda.

e. *Exchange Review of NFA Investigations*

As described above (*see supra* Section V.B.1), once the Compliance Director receives the investigative report from NFA, he reviews the report and makes the final decision as to what Exchange action, if any, will be taken. The Compliance Director can (i) remit the matter back to NFA for further investigation; (ii) forward the investigative report to a disciplinary panel with or without a recommendation; (iii) issue a warning letter or guidance to the investigated party; or (iv) close the investigation with no action.

Pursuant to the RSA with NFA, if the Compliance Director closes an investigation without referral to a disciplinary panel, the Compliance Director is to notify NFA in writing of this decision and the reasons for not forwarding NFA's investigative report to a disciplinary panel. Similarly, pursuant to ELX's rules, the Compliance Director must provide a written

---

<sup>36</sup> *See* 2012 NYSE Liffe Review at 27 (recommending that "NYSE Liffe's CRO receive and promptly review reports of all inquiries closed by NFA to monitor the sufficiency of NFA's inquiry process and the adequacy of NFA's substantive determinations."). As described in more detail *supra* note 17, NFA was not able to implement this recommendation during ELX's target period.



explanation to NFA if the Compliance Director closes an investigation through informal disposition, such as by issuing a warning letter or guidance for future conduct, or closes an investigation with no action.<sup>37</sup>

Division staff reviewed four market surveillance-related warning letters sent via email by the Exchange. Three letters were sent during the target period, and one warning letter was sent after the target period in connection with an investigation that NFA had closed during the target period. In each of the investigations, the Exchange issued a warning letter because it was a first-time violation, a result of systems or technical issues, and/or the Exchange believed it involved an isolated occurrence. The warning letters included a summary of the facts, the details of why the action was taken, and what rule(s) were violated. In the warning letters, the Exchange advised either that a second offense would be or would likely be referred to a disciplinary panel and result in the imposition of a summary fine of up to \$5,000. The Exchange copied NFA on the emails to inform NFA of its action, and to allow NFA to include them in any future investigative reports involving the party.

Division staff found that although NFA was informed as to the reasons why the Exchange had issued the warning letters by virtue of receiving a copy of the warning letters, in only one investigation did the Exchange send NFA a written explanation concerning its reasons behind issuing the warning letter. The Division believes that the Exchange's actions in the market surveillance investigations, and its decision to issue warning letters rather than refer the investigations to a disciplinary panel, were appropriate. The Division is concerned, however, that the Exchange did not routinely prepare a written memorandum to NFA explaining its

---

<sup>37</sup> See ELX Rule VII-5(c).

reasons to close an investigation through means other than forwarding it to a disciplinary panel, as required by the RSA and the Exchange's rules. Accordingly, the Division recommends:

- **The Exchange prepare a written memorandum and submit it to NFA for any investigation referred by NFA and not forwarded to a disciplinary panel, including information sufficient to explain the reasons for the final action (i.e., issuing guidance or a warning letter) or non-action taken. The memoranda should also include an explanation to the extent that the Exchange issues a warning letter that differs from the potential rule violation(s) cited by NFA in the investigative report.**

3. Inquiry and Investigation Logs and Reports

a. *NFA's Case Ageing Report*

NFA's case ageing report tracks inquiries and investigations opened and closed by NFA.<sup>38</sup> The case ageing report lists the case number, NFA "open date," NFA "close date," number of days open by NFA, trade date, firm name, allegation, action, and status. The case ageing report is sent monthly to the Exchange to allow it to determine whether inquiries and investigations are resolved in a timely manner.

b. *The Exchange's Investigation Log*

The Exchange also maintains its own investigation log, which lists all of NFA's investigations, as well as the Exchange's internal inquiries and investigations related to audit trail or financial surveillance. The Exchange's investigation log contains information concerning the "date opened," the date NFA's investigative report was received by the Exchange, whether the Exchange referred the investigation to a hearing panel, and the date when the Exchange closed the case and what action the Exchange took (if any).

---

<sup>38</sup> The case ageing report listed the inquiries and investigations opened and closed by NFA during the target period with the exception of one inquiry. *See supra* Section V.B.2.b.

c. *Adequacy of Inquiry and Investigation Logs and Reports*

Division staff reviewed NFA's case ageing report and the Exchange's investigation log in connection with the rule enforcement review. With respect to NFA's case ageing report, Division staff noted that NFA's case ageing report does not provide the date when an inquiry is elevated to an investigation. Further, in some instances, there were periods between the date when NFA staff first contacted a trader concerning potentially violative activity, and a later "open date" used in the case ageing report. Since the time spent before the "open date" is not accounted for in NFA's case ageing report, the case ageing report does not fully reflect the time that NFA spent investigating a matter. For instance, in case number 2011MINV2393, NFA's "open date" in the case ageing report is October 21, 2011, even though NFA first contacted the firm for information a month earlier on the trade date, September 21, 2011, and NFA and the Exchange had contacted the firm a number of times in the three weeks following the trade date.

In addition, in some investigations, Division staff noticed that the "date opened" in the Exchange's investigation log was different from the "open date" NFA used in its case ageing report. For example, in case number 2011MINV2393, the Exchange's log uses the earlier date of when NFA first began corresponding with the firm as the "date opened," and NFA's case ageing report uses an "open date" a month later.<sup>39</sup> Similarly, because the Exchange's investigation log uses the date of when the Exchange closes an investigation and NFA's case ageing report uses the date of when NFA closes the investigation, the relevant case dates do not

---

<sup>39</sup> In another instance, Division staff noted that the Exchange did not have an investigation listed on its investigation log submitted to the Division, because the Exchange used a "date opened" after the target period had ended. NFA, however, had that same investigation listed on its case ageing report with an "open date" months earlier. In documents submitted after the interview with Exchange personnel, the Exchange changed the "date opened" of this investigation to reflect that it was opened on the same date that NFA indicated.

always match up when comparing the log and case ageing report.<sup>40</sup> Moreover, NFA's case ageing report calculates the time between when NFA opens and closes a case (i.e., between when NFA opens an inquiry and submits an investigative report to the Exchange), but it does not include when the Exchange closes the case.

For all these reasons, it may be difficult for the Exchange or Division staff to evaluate the timeliness of NFA's opening and closing of inquiries and investigations, and for Division staff to track the relevant dates from NFA's opening an inquiry through the Exchange's closure of the case. The Division is cognizant that a recommendation was previously made in a rule enforcement review of another exchange that uses NFA for regulatory services regarding NFA's case ageing report, and that NFA promptly made the change.<sup>41</sup> The Division, however, continues to be concerned about the amount of effort required to track the opening and closing of inquiries and investigations. Moreover, the Division believes a more detailed, consistent approach to tracking the opening and closing of inquiries and investigations provides more transparency with respect to determining whether the same firm(s) is engaging in violative behavior within a rolling 12-month period.<sup>42</sup> Accordingly, the Division recommends that NFA's case ageing report and

---

<sup>40</sup> Division staff noted that one investigation was not included on NFA's case ageing report for the target period that was produced to the Division, because NFA closed the case before the target period, but the Compliance Director had closed it during the target period, making it a relevant case for the Division's review.

<sup>41</sup> See 2012 NYSE Liffe Review at 28-29 (recommending that "[a]ll logs maintained by NFA note the date of the initial trade exception or other activity that led to an inquiry or an investigation.").

<sup>42</sup> The Division is not suggesting that both NFA and the Exchange's log have to be exactly the same; however, a log should make clear what date it is using, for example, as the case "open" date, use the dates consistently, and contain enough information to meaningfully convey the relevant dates for the case from its opening to its final disposition. In the event that NFA is responsible for creating and maintaining the inquiry and investigation tracking logs for an exchange, the Division suggests that NFA's case ageing report include all of the relevant dates necessary to track an inquiry or investigation from its opening to the final action taken by the Exchange.

the Exchange's investigation log include all of the dates necessary to track an inquiry/investigation from its opening to its final disposition, specifically:<sup>43</sup>

- **The “open date” NFA uses in its case ageing log to indicate that it has opened an inquiry should be the date it first contacts a market participant for information, or NFA should provide the Exchange with another means of accounting for the time spent by NFA prior to the “open date.”**
- **The Exchange's investigation log should note the date of the initial trade or activity that led NFA to open the inquiry.**

#### 4. Timeliness of Completing Inquiries and Investigations

The Division reviewed the length of time between when NFA opened and closed cases during the target period, and when the Exchange closed investigations referred to it by NFA. The three market surveillance investigations NFA closed during the target period were opened by NFA as inquiries and closed by NFA and the Exchange within approximately 10 months or less. The market surveillance inquiry NFA opened and closed administratively during the target period was closed within approximately three months of opening the inquiry. The Exchange also closed a market surveillance investigation that NFA had closed prior to the target period within approximately five months of NFA opening the inquiry. Accordingly, Division staff believes that NFA and the Exchange closed the market surveillance cases within a reasonable amount of time.<sup>44</sup>

---

<sup>43</sup> See also *supra* Section V.B.2.c and the Division's recommendation made therein.

<sup>44</sup> As discussed *supra* Section V.B.2.c, Division staff is unable to evaluate the timeliness of when NFA's inquiries were elevated to investigations because those dates are not included in NFA's investigative reports or case ageing log, but notes that it would not have affected the conclusion here as to the timeliness of the inquiry/investigation process.

## C. Market Surveillance Systems

### 1. Exchange's Market Monitoring Systems

As discussed above (*see supra* Section V.A.1), the Exchange is responsible for real-time market monitoring and surveillance. The Control Desk is responsible for real-time monitoring of ELX's market operations and providing technological and operational support, and the Compliance Department is responsible for market surveillance and regulatory compliance. The Exchange relies on the following systems for real-time monitoring and automated alerts:

- *ELX Position Monitor.* The ELX Position Monitor is an application used to view intra-day positions in real-time. The ELX Position Monitor generates automated large intra-day position alerts when (i) a particular user acquires a net position/open interest ratio that meets or exceeds 25 percent for any particular contract month; or (ii) if the net position meets or exceeds 50 percent of the Exchange-established position accountability levels per contract month.
- *ELX Price Monitor.* The ELX Price Monitor produces automated alerts for any trades that are more than a configurable number of ticks away from the most recent last price.
- *ELX Reject Monitor.* The ELX Reject Monitor produces automated alerts of select error conditions and order rejections.
- *ELX Order Book Monitor.* The ELX Order Book Monitor is used to view real-time details of every live order on the Exchange, and can be used to view orders by market participant or contract.

The parameters for the automated alerts are established by the Compliance Director. The Control Desk supervisor is responsible for reviewing the automated alerts, except when a large intra-day position alert is generated by the ELX Position Monitor alert. If a large intra-day position alert is generated, the Compliance Department is responsible for reviewing the alert to determine whether the market participant is approaching or exceeding position limits, and whether the position is reasonable relative to the capital position of the relevant parties and to the

total open interest in the contract.<sup>45</sup> The Control Desk also notifies the Compliance Department if the ELX Position Monitor generates an alert for a net position that meets or exceeds 50 percent of the Exchange-established position accountability levels. In addition, if a high volume of any alert is produced by ELX's systems, the Control Desk will escalate matters to the CEO and/or Compliance Director.

## 2. NFA's Market Surveillance Systems

NFA is responsible for ELX's market surveillance, other than real-time monitoring of market transactions, and conducts market surveillance daily on a next-day ("T+1") basis.<sup>46</sup> NFA's Market Regulation Procedures detail NFA's market surveillance procedures.

NFA's in-house trade practice and market surveillance system, Webfocus, produces automated alerts to notify staff of activity or circumstances that may require following up, and screens or reports that staff can use to analyze specific activity. Automated alerts can be generated at the firm, trader, or account level. Alerts specifically related to market surveillance include alerts for monitoring large traders, firm open interest vs. overall contract open interest, and daily price changes over certain timeframes set by NFA.<sup>47</sup> Alerts generated by Webfocus are reviewed on a T+1 basis each morning by a manager and/or senior manager. If staff believes a generated alert may indicate a potential rule violation or problematic activity, staff can reach out to the firm or to the Exchange for clarification, verification, or documentation, and may open an inquiry if the circumstances warrant. Webfocus also generates reports or screens that are used to analyze trade activity, including the positions of large traders. In addition, Webfocus

---

<sup>45</sup> In the event the Deputy Compliance Director or Compliance Director is unavailable, the Control Desk is responsible for the initial review of the alert. If the position is in excess of established open interest thresholds or position accountability levels, the Control Desk contacts the Compliance Department.

<sup>46</sup> NFA and the Exchange do not conduct any related surveillance with respect to the Agricultural futures or Coupon futures because there has been no volume in those contracts.

<sup>47</sup> Large trader alerts and reports are discussed in more detail *infra* Section V.E.

maintains the case ageing report and the “notes” system, where staff document their review of reports or alerts generated by Webfocus. The Portal hosts various documents and logs used by staff in connection with their trade practice and market surveillance tasks, including the case status update, logs for tracking reviews of EFRP transactions, and closed inquiry/investigation files.

NFA staff also gathers information from third-party resources, including Bloomberg News Service (“Bloomberg”) and CQG, which staff utilizes in monitoring pricing, volume, market events, and historical data metrics. Finally, NFA staff has “read only” access to the Exchange’s real-time monitors and can review trade activity on a real-time basis, although real-time monitoring is primarily used as a reference tool or supplement for NFA’s market surveillance.

#### **D. Routine Surveillance of Market Fundamentals**

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

NFA analysts are responsible for monitoring market news, as well as pricing, volume, and open interest information in his or her assigned exchange. At the beginning of each day, an analyst reviews the previous day’s trading activity on the Exchange by reviewing the Exchange Profile generated by Webfocus. The Exchange Profile lists information on volume and open interest at the Exchange level, contract level, and by clearing firm, trader, or account. The Exchange Profile also includes the previous day’s off-Exchange activity and indicates the contracts’ high/low settlement price. Analysts also review the Exchange’s open interest by reviewing the Large Trader Position screens on Webfocus, including all open positions by clearing firm and by contract, and the associated large trader positions.<sup>48</sup> In addition to

---

<sup>48</sup> NFA’s Large Trader Position screens are discussed in more detail *infra* Section V.E.1.



consulting these sources, staff reviews any automated alerts generated by Webfocus concerning open interest or price changes on the Exchange.

Staff also reviews market news, pricing, and volume information from third-party sources, including Bloomberg and CQG. In addition, NFA has various Bloomberg screens that track the instruments underlying ELX's U.S. Treasury futures.

## 2. Deliverable Supply

Although futures contracts that require the delivery of a financial instrument are less likely than futures on physical commodities to be subject to manipulation in the form of a squeeze, NFA nevertheless monitors the available supply, including the size of particular issues that are cheapest to deliver.<sup>49</sup> In addition, staff will scrutinize conversion factors on any particular delivery instrument in the financial markets to understand if there will be a large or small conversion factor on the final settlement day.

The Division believes NFA has an effective procedure for routine surveillance of ELX's market fundamentals, including the monitoring of price, volume, open interest, and deliverable supply. Accordingly, the Division has no recommendations in this area.

## **E. Monitoring of Large Traders and Position Levels**

### 1. Monitoring of Large Traders

The Exchange requires ELX Participants (on behalf of themselves and customers) and Authorized Customers to submit large trader reports when reportable position levels meet Exchange-established thresholds for a contract.<sup>50</sup> These reports must be delivered via secure

---

<sup>49</sup> Cheapest to deliver refers to the selection of a class of bonds or notes deliverable against an expiring bond or note futures contract. The bond or note that has the highest implied repo rate is considered the cheapest to deliver.

<sup>50</sup> See ELX Rule IV-14; ELX, *Regulatory Reporting Guide* (June 11, 2009), [http://elxfutures.com/getdoc/df854a70-20c6-4467-a989-094b529f5d18/ELXNTP-REG-09001DRAFT5\\_061109.aspx](http://elxfutures.com/getdoc/df854a70-20c6-4467-a989-094b529f5d18/ELXNTP-REG-09001DRAFT5_061109.aspx). Reportable levels are provided under the contract terms in ELX Rule IX.

FTP protocol to ELX by 9:00 a.m. ET the business day following the date in which the account becomes reportable. NFA receives the large trader reports from the Exchange that morning, and processes and uploads them to Webfocus.

ELX Participants and Authorized Customers who identify a trader with positions over the reportable level are required to email ELX a copy of their CFTC Form 102 (“Identification of Special Accounts”) within one business day of the account becoming reportable, and a copy to NFA within three business days of sending it to ELX.<sup>51</sup> The information contained on each Form 102 is input into Webfocus. Once the information is input, it can be searched, and if required, reporting accounts can be aggregated.

As part of their daily market surveillance duties, NFA staff reviews and analyzes the large trader reports, as well as any generated automated alerts, on a T+1 basis. Once the large trader position reports are processed and uploaded by NFA, Webfocus generates the following large trader-related automated alerts:

- new large trader (indicating a potential need for a Form 102);
- large trader position exceeding a reportable level (indicating same);
- large trader position greater than open interest (indicating potential reporting issues regarding open interest); and
- large trader position exceeding position limits (indicating a potential violation of Exchange rules and/or the need for a hedge exemption or trading restrictions).

Webfocus also produces five different large trader screens that allow NFA staff to further analyze the automated alerts and large trader activity:

---

<sup>51</sup> Form 102 is designed to comply with the provisions of Commission Regulation 17.01(b). The form provides information on the account’s ownership and control, and identifies futures and options traders who trade for the account. It also provides information to the Exchange and NFA that enable them to, among other things, track the positions of large traders, ensure compliance with position limits and monitor concentration of positions by those that own and/or control positions in the futures markets.

- *Large Trader Analysis.* The Large Trader Analysis screen reflects large trader positions compared to position accountability levels and position limits.
- *Large Trader Trend.* The Large Trader Trend screen lists all large trader positions by specific contract over a period of time, along with changes to the positions.
- *Large Trader Position.* The Large Trader Position screen compares large trader positions to open interest, which NFA uses to detect any potential reporting issues.
- *Large Trader Search.* The Large Trader Search screen allows staff to search all Form 102s filed with NFA, in order to determine whether any reporting accounts may need to be aggregated for position limit purposes.
- *Large Trader Maintenance.* The Large Trader Maintenance screen is used to aggregate reporting accounts, and establish omnibus account relationships.

Any issues or concerns noted by an analyst during review of these large trader alerts or screens is documented in notes, and are reviewed on a daily basis by a manager or senior manager.

During the target period, NFA opened one inquiry based on its daily review of open interest and large trader data for a firm's failure to timely and properly submit a large trader report and Form 102 for a reportable account. The inquiry was elevated to an investigation and referred to the Exchange, which issued a warning letter.<sup>52</sup>

The Division believes that NFA's tools are sufficient to assist staff in monitoring large traders and position levels, and that the Exchange's issuance of a warning letter in the large trader investigation was appropriate. Accordingly, the Division has no recommendations in this area.

## 2. Monitoring of Position Accountability Levels

The Exchange's position accountability levels serve as a threshold that can trigger additional scrutiny of a position and allow the Compliance Department to address potential

---

<sup>52</sup> In case number 2011MINV2393, the Exchange determined that the firm failed to deliver the required large trader information because of system issues and an administrative oversight that caused it to apply the wrong reportable level. As a result, the Exchange issued a warning letter to the firm for a violation of Rule IV-14 (Required Reports).

market problems. During the target period, the Exchange's Interest Rate futures were subject to all-months-combined position accountability levels.<sup>53</sup> These levels were set when the products were launched, based on the levels specified for the same contracts trading on CBOT and CME.<sup>54</sup>

As noted above (*see supra* Section V.E.1), NFA uses Webfocus's alerts and large trader screens to monitor large trader positions compared to position accountability levels. When the size of a large trader's position reaches or exceeds the applicable position accountability level, it does not automatically result in NFA requesting further information or opening an inquiry. When a position accountability level is triggered, the Exchange and the respective participant are notified by NFA via an email that the participant has exceeded the Exchange's accountability level in the respective contract, and that the recipient should contact the Compliance Director with any questions.

Upon receiving the email from NFA, the Compliance Director reviews the size of the position, open interest in a particular contract month, the delivery period, and market conditions at the time. The Compliance Director then makes the determination as to whether it is necessary to request additional information from the participant, issue guidelines, or request that NFA track the position or open an inquiry.

Exchange rules give the Exchange the authority to direct a market participant to limit or reduce any position exceeding position accountability levels where it determines this to be

---

<sup>53</sup> ELX Rules IX-101 through IX-106.

<sup>54</sup> After the target period, ELX added single month position accountability levels for the U.S. Treasury futures and single month and all-months-combined position accountability levels for the Coupon futures. *See id.*

necessary.<sup>55</sup> If the Exchange directs a participant to hold or reduce a position, in addition to NFA, the Division is notified within one business day of that action. Although the Exchange will invoke the position accountability rules if necessary, it did not find an occasion during the target period where it needed to request additional information, open an inquiry or investigation, or issue an order to limit or reduce a position.

Division staff reviewed the three position accountability notices sent to market participants during the target period. The Division found that the Exchange does not maintain any written documentation or log regarding the Compliance Director's review of the notices from NFA or assessment of whether the positions warrant any further action by NFA or the Exchange. Without a log or other documentation, the Division cannot evaluate whether the Exchange is reviewing and assessing the positions after receiving the notices from NFA.

Accordingly, the Division recommends:

- **The Exchange maintain a log documenting its review and assessment of notices from NFA to market participants who have reached or exceeded a position accountability level.**

### 3. Monitoring of Position Limits

The Exchange's speculative position limits bar a market participant from holding or controlling a net futures equivalent position during a specified period that exceeds the position limit specified by the Exchange for that contract. The particular position limit may be adjusted in individual instances by a hedge exemption granted to the participant by the Exchange (discussed *infra* Section V.E.4). The Exchange's Agricultural futures and U.S. Treasury futures

---

<sup>55</sup> ELX Rule IV-12(b) provides that the Exchange can order a trader that has exceeded position accountability levels not to increase a position, and ELX Rule IV-20(a) provides that ELX Management can order a trader to liquidate a position in the case of an emergency.

are subject to position limits.<sup>56</sup> ELX's Agricultural futures are subject to spot, single month, and all-months-combined position limits.<sup>57</sup> The spot month period varies by contract and is defined in the rule for each contract. During the target period, the position limits for the U.S. Interest Rate futures applied to the last 10 trading days of the expiring futures month, and barred a market participant from holding or controlling a net futures equivalent position in that month which exceeded the position limit specified by the Exchange for that contract.<sup>58</sup>

As discussed above (*see supra* Section V.E.1), NFA uses Webfocus's alerts and large trader screens to monitor position limits. Exceeding a position limit without previously having obtained a hedge, arbitrage, or spread transaction exemption is a violation of the Exchange's rules.<sup>59</sup>

None of the Exchange's market participants have reached or exceeded a position limit since the Exchange was designated. Accordingly, the Division was unable to review an Exchange response to when a market participant reaches or exceeds a position limit.

#### 4. Exemptions from Position Limits

Although all market participants are subject to the Exchange's position limits where applicable, the Exchange may grant exemptions from position limits to participants holding bona fide hedge, arbitrage, or spread positions. Upon application to the Exchange for a hedge exemption, a transaction that qualifies as a qualified hedge transaction is automatically exempt

---

<sup>56</sup> ELX Rules IX-101 – IX-106; ELX Rules IX-201 – IX-205.

<sup>57</sup> ELX Rules IX-201 – 205.

<sup>58</sup> After the target period, ELX amended its rules to change the position limits for U.S. Interest Rate futures to spot position limits, which vary by contract. *See* ELX Rules IX-101 – IX-105. ELX's Coupon futures, added after the target period, also have spot position limits that vary by contract. *See* ELX Rules IX-107 – IX-111.

<sup>59</sup> ELX Rule IV-11.

from the position limits that would otherwise apply.<sup>60</sup> In the hedge exemption application, the applicant must:

- (i) represent that the transaction or position constitutes a qualified hedge transaction and is not used in an attempt to violate or avoid Exchange rules;
- (ii) represent that it is necessary or advisable as an integral part of the participant's business and provide an explanation of its business;
- (iii) represent that the applicant has complied with any federal requirements and received any necessary approvals from the Commission;
- (iv) provide a schedule of the maximum number of contracts the participant intends to enter into;
- (v) agree to comply with additional limits the Exchange may impose; and
- (vi) agree to promptly submit a supplemental statement explaining any change in circumstances that may affect the nature of its positions.<sup>61</sup>

A hedge exemption must be renewed annually by filing a new application.

In addition, a market participant can apply for an arbitrage or spread transaction exemption. In the application, the applicant must provide the information in prongs (iii)–(vi) above, and in addition:

- (i) represent that the transaction or position constitutes a qualified arbitrage or spread transaction and is not used in an attempt to violate or avoid Exchange rules;
- (ii) provide information concerning the extent of the applicant's current or planned activity in the relevant underlying physical; and
- (iii) represent that the positions involved are moved in an orderly manner and not initiated or liquidated in a manner calculated to cause unreasonable price fluctuations or unwarranted price changes.<sup>62</sup>

The Exchange can impose limitations on arbitrage and spread transaction exemptions, if necessary, in light of the liquidity of the markets involved and the market participant's financial

---

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> ELX Rule IV-11(c).

condition and business circumstances.<sup>63</sup> An arbitrage or spread transaction exemption lasts for a period of one year, unless the Exchange believes conditions warrant a shorter period.

None of the Exchange's market participants have applied for a hedge, arbitrage, or spread transaction exemption since the Exchange was designated. Accordingly, the Division was unable to review applications for exemptions or the Exchange's process for reviewing and granting exemptions.

#### **F. Surveillance of Expiring Contracts**

NFA heightens surveillance of expiring contracts in order to detect and prevent price manipulations and facilitate orderly liquidations. During a contract expiration month, NFA begins heightened surveillance for ELX's contracts on the first and second Tuesdays of the month, and during the last two weeks immediately before expiration. An analyst or manager gathers information from the Commission's Commitment of Traders Report; volume and open interest information from CME, CBOT, and ELX; and price information from Bloomberg. The analyst/manager conducts a review of the trading and positions of large traders in light of the current state of open interest and the size and ownership of deliverable supply, monitors cash prices, and analyzes whether the basis relationship indicates any potential liquidation issues. This review and analysis is documented in the Delivery Checklist that NFA prepares for ELX, and is maintained on the Portal. As the Delivery Checklist is being prepared, NFA maintains contact with ELX's Compliance Director to discuss any potential anomalies or delivery issues.

In addition to NFA's surveillance, the Compliance Director reviews positions in the days leading up to the spot date, and routinely evaluates delivery obligations based on his knowledge of the experience and financial capabilities of the Exchange's market participants. Although NFA staff has the ability to contact market participants, the Compliance Director is primarily

---

<sup>63</sup> *Id.*



responsible for contacting market participants with respect to contract expiration and deliveries, and sends out courtesy email notifications to market participants regarding positions held leading into the delivery period. During the target period, neither NFA nor the Exchange identified any problematic expirations.

The Division believes that NFA and the Exchange have adequate procedures for the surveillance of expiring contracts. Accordingly, the Division has no recommendations in this area.

## **G. Monitoring of EFRP Transactions**

### **1. Overview of ELX's EFRPs**

ELX Rule IV-16 provides that four types of EFRP transactions can “be executed outside of the ELX System” in accordance with the requirements of this Rule and cleared through the Clearinghouse as if it were a transaction executed on the ELX System: (i) Exchange of Futures for, or in connection with, cash commodities (“Exchange for Physical Transactions” or “EFPs”); (ii) Exchange of Futures for, or in connection with, swap transactions (“Exchange for Swap Transactions” or “EFSs”); (iii) Exchange of Futures for, or in connection with, over-the-counter derivatives transactions (“Exchange for Risk Transactions” or “EFRs”); and (iv) Exchange of Futures for, or in connection with, futures transactions (“Exchange for Futures Transactions” or “EFFs”).

During the target period, 2,891 Exchange contracts (i.e., less than one percent of the Exchange’s contract volume during the target period), were executed through 116 EFRP transactions.<sup>64</sup> The vast majority of the EFRP transactions consisted of basis trades that were electronically matched as EFPs by a third party system (“matched EFRPs”). The remaining

---

<sup>64</sup> The Exchange conveyed to Division staff that during the target period the Exchange’s EFRP volume consisted of EFP transactions in the U.S. Treasury futures.

EFRP transactions were negotiated transactions conducted between the counterparties or by voice or electronic broker (“negotiated EFRPs”).

Pursuant to Rule IV-16, an EFRP’s “related position” (i.e., cash, swap, future, or OTC derivative) must involve the commodity underlying the futures contract, or must be a derivative, by-product or related product of such commodity that has a reasonable degree of price correlation or other significant price relationship to the commodity underlying the futures contract. Rule IV-16 provides that an EFRP transaction consists of two discrete but related simultaneous transactions, and that one party must be the buyer of (or the holder of the long market exposure associated with) the related position and the seller of the corresponding futures contract; and the other party must be the seller of (or the holder of the short market exposure associated with) the related position and the buyer of the corresponding futures contract. Further, the quantity covered by the related position must be approximately equivalent to the quantity covered by the futures contracts and entered into in accordance with the applicable price increments set forth in the rules, at such prices as are mutually agreed upon by the parties to the transaction. The Exchange requires that accounts involved on each side of an EFRP must have different beneficial ownership, be under separate control, or involve separate legal entities.

Rule IV-16 also provides that each EFRP must be cleared through the Clearinghouse as if it were a transaction executed on the ELX System. Each EFRP must be reported to the Clearinghouse, including the time the EFRP transaction was executed, by a Clearing Privilege Holder acting on its own behalf or for the beneficial account of a customer who is a party to the transaction. The Exchange also requires that the parties’ account statements designate the transaction as an EFRP. Finally, the parties to a transaction must maintain all documents relevant to the future and the related transactions, including all documents customarily generated

in accordance with cash or other relevant market practices, and any documents reflecting payment and transfer of title. These documents must be provided to the Exchange upon its request.

2. NFA's Monitoring and Review of EFRPs

The RSA provides that NFA will perform a continuous review of selected EFRP transactions and their supporting futures and cash/swap documentation to determine whether the EFRP transactions were bona fide transactions and were executed with the Exchange's prescribed guidelines. In practice, the continuous review is a cursory review of all transactions identified as EFRPs (including both matched EFRPs and negotiated EFRPs) in the Exchange's audit trail data, conducted on a T+1 basis. NFA reviews the pricing, quantity, timing, and firm/accounts involved in the transaction, but this review does not involve requesting underlying documentation.

In addition to the continuous review process described in the RSA, once a month, based on the level of Exchange activity, NFA will randomly select an EFRP transaction(s) to review in more depth. This review is opened as an inquiry, although this does not necessarily indicate that an Exchange rule has potentially been violated.<sup>65</sup> The selection process to determine the population of potential inquiries is conducted and documented by a manager and/or senior manager. The population is then further reviewed by a more senior employee (i.e., either a senior manager or the Associate Director) to determine whether staff is opening what the senior manager or Associate Director considers to be any redundant or unnecessary inquiries. Accordingly, depending on Exchange EFRP volume and the selection process, there may be

---

<sup>65</sup> See *supra* Section V.B, which provides more detail on NFA's inquiry and investigation process.

instances where NFA does not open an inquiry for an EFRP transaction during a given month or for a Clearing Privilege Holder during a given year.

When an EFRP inquiry is opened, NFA requests and reviews documentation from the respective parties to determine if the EFRP transaction is bona fide and in compliance with Exchange rules. Requested documentation generally includes all relevant daily account statements, order tickets or blotters for the EFRP transaction, documents supporting the cash component of the EFRP transaction, records pertaining to any back office transactional activity, identification of the ultimate account owner(s) or controller(s), and any other relevant documentation that supports the requirements for the execution and reporting of the transaction. NFA will review and analyze the documents to confirm that (i) there were two separate parties involved; (ii) in two discrete simultaneous transactions; (iii) there was a reasonable price and quantity correlation to the futures and cash being exchanged relative to the day's trading range; and (iv) that the relevant account statements designated the transaction as an EFRP. Upon completion of NFA's review, the inquiry is closed administratively by NFA with a closing memorandum, or elevated to an investigation and referred to the Exchange.

Although NFA had initially included matched EFRPs in its random review selection, during the target period the Exchange decided not to include them in NFA's random review selection because the transactions were electronically matched and included in NFA's continuous review of EFRP transactions. During the target period, NFA opened inquiries based on randomly selecting a negotiated EFRP transaction from two of the four Clearing Privilege Holders that cleared negotiated EFRP transactions during the target period. NFA did not review EFRP transactions from the other two Clearing Privilege Holders during the target period because they had only executed matched EFRPs.

The Division believes that NFA should have a more robust process for reviewing more EFRP transactions to verify that the transactions are bona fide and the parties to an EFRP transaction maintain relevant documents pursuant to ELX Rule IV-16. In addition, the Division believes that an improved EFRP-monitoring process would enhance NFA's ability to detect non-bona fide EFRP transactions and, in turn, deter parties from entering into non-bona fide EFRP transactions.

First, the Division believes that NFA should request documentation for and verify the bona fides of EFRP transactions from every Clearing Privilege Holder that clears EFRPs on the Exchange every calendar year, and depending on volume, review multiple EFRP transactions across every product category, as well as different types of EFRP transactions, if applicable.<sup>66</sup> Second, the Division believes that matched EFRPs should be included in the existing pool of EFRP transactions subject to NFA's monthly reviews of random EFRP transactions.

Finally, while the Division believes that NFA may utilize a degree of randomization in selecting EFRPs for verification, NFA should also choose more EFRPs with an eye to detecting potentially violative transactions. In addition to the cursory review process described in the Market Regulation Procedures, NFA should also closely examine, among other things, (i) transactions where a participant rolls positions (i.e., liquidates a position for one delivery month and then reestablishes it for the next delivery month), does not ordinarily engage in EFRPs, executes an EFRP in an unusual amount of contracts, executes an EFRP tied to a spread transaction, or executes an EFRP in a product market where EFRP activity is not ordinarily observed; (ii) EFRPs involving an unusually small number of contracts such as one-lot EFRPs,

---

<sup>66</sup> The Division believes that if the type or nature of EFRP transactions on the Exchange changes in the future (i.e., the Exchange gains EFS or EFR transaction volume or EFRP volume in other product categories), NFA should also conduct reviews of EFS and EFR transactions and expand its review to include other product categories.

EFRPs just below the respective block size threshold, and EFRPs between affiliates; and (iii) parties that conduct a large number of EFRPs or that execute offsetting EFRPs on the same day.

Accordingly, the Division recommends:

- **Matched EFRPs be included in the existing pool of transactions subject to random review.**
- **Although NFA may utilize a degree of randomization in selecting EFRPs for verification, NFA should strategically select more EFRP transactions for review with an eye to detecting misconduct.**
- **NFA ensure that it reviews EFRP transactions from every Clearing Privilege Holder that clears EFRPs on the Exchange every calendar year.**

### 3. EFRP Inquiries and Investigations

During the target period, NFA opened three inquiries as part of NFA's monthly random review of EFRP transactions:<sup>67</sup> one inquiry was closed administratively by NFA (2011MINV2786); one inquiry was elevated to an investigation and referred to the Exchange, which issued a warning letter (2012MINV00412);<sup>68</sup> and one inquiry was subsequently deleted by NFA (*see supra* Section V.B.2.b). NFA also opened one EFRP inquiry during the target period at the Exchange's request that was elevated to an investigation and referred to the Exchange, which issued a warning letter (2011MINV0974).<sup>69</sup> In addition, the Exchange sent a warning

---

<sup>67</sup> NFA only opened three inquiries of randomly selected EFRP transactions during the target period because the vast majority of the EFRP transactions were matched EFRPs.

<sup>68</sup> In case number 2012MINV00412, NFA reviewed an EFP transaction between two separately controlled accounts of the Clearing Privilege Holder. NFA found that the transaction was bona fide; however, it referred the investigation to the Exchange because the daily account statements did not designate the transaction as an EFRP, as required by Rule IV-16(i). The Exchange found that it appeared to be an isolated event and issued a warning letter for a violation of Rules IV-16 (Exchange of Futures for Related Positions) and V-1 (Books and Records; Cooperation in Proceedings).

<sup>69</sup> In case number 2011MINV0974, ELX's Compliance Department requested that NFA review an EFP transaction between two separately controlled accounts of the Clearing Privilege Holder that was not reported to the Exchange until four days after the transaction was executed. NFA found that the transaction was bona fide; however, it referred the investigation to the Exchange because the transaction was submitted after the deadline required by Rule IV-16(h). The Exchange found that the firm had made a back office system processing error, and had corrected the

letter in connection with an EFRP inquiry and investigation that NFA had closed prior to the target period (2010MINV2104).<sup>70</sup>

The Division found that NFA's research and case files were typically well-documented and included pertinent underlying trade documents, email correspondence, computer reports, and summaries of the activity examined. The investigative reports and the memorandum to close the inquiry contained a description of the review and investigation conducted, and sufficient information for Division staff to make an informed decision regarding the adequacy of the investigation. Moreover, the Division found that the Exchange's issuance of warning letters was appropriate.

\*\*\*\*\*

---

error as soon as it was discovered. The Exchange issued a warning letter for a violation of Rule IV-16 (Exchange of Futures for Related Positions).

<sup>70</sup> In case number 2010MINV2104, NFA reviewed five 10-lot matched EFRP transactions between accounts from two separate Clearing Privilege Holders. NFA referred the investigation to the Exchange because one of the Clearing Privilege Holder's trade statements did not designate the transactions as EFRPs, as required by Rule IV-16(i). The Exchange found that the Clearing Privilege Holder's apparent failure to designate the transactions as EFRPs was a system configuration issue, and that the customer was fully aware that the matched EFRPs were EFRP transactions. The Exchange issued a warning letter for a violation of Rules IV-16 (Exchange of Futures for Related Positions) and V-1 (Books and Records; Cooperation in Proceedings).