

Rule Enforcement Review of the Chicago Board of Trade



Division of Trading and Markets

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RULE ENFORCEMENT REVIEW OF THE CHICAGO BOARD OF TRADE

I. INTRODUCTION: PURPOSE AND SCOPE

The Division of Trading and Markets (“Division”) has completed a rule enforcement review of the trade practice surveillance and disciplinary programs of the Chicago Board of Trade (“CBT” or “Exchange”) for compliance with Sections 5a(a)(8) and 5a(b) of the Commodity Exchange Act (“Act”) and Commission Regulation 1.51.¹ The review covers the period of October 1, 1998, through September 30, 1999 (the “target period”).²

In conducting its review, Division staff examined Exchange documents that included, among others, computer reports generated by the CBT’s automated trade practice surveillance system and other documentation used routinely in the conduct of surveillance; trade practice investigation and disciplinary logs; selected trade practice investigations and disciplinary action case files; minutes of disciplinary committee meetings; and compliance manuals and guidelines. In addition, Division staff interviewed officials of the Exchange’s Office of Investigations and

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

² The Division’s last rule enforcement review of the Exchange’s compliance program was presented to the Commission on February 12, 1997 (“1997 Review”). In the 1997 Review, the Division found that the Exchange generally had adequate trade practice surveillance and disciplinary programs, but needed to improve the timeliness of its investigations. A similar finding with respect to timeliness is made in the current review. A copy of the 1997 Review can be found in Appendix 1.

Audits (“OIA”), including the Vice President of OIA and the Managing Director of OIA’s Investigations Department.³

The Division gave the CBT an opportunity to review and comment on a draft of this report on June 8, 2000. On June 15, 2000, Division staff conducted an exit conference with CBT officials to discuss the report’s findings and recommendations.

II. TRADE PRACTICE SURVEILLANCE – Sections 5a(a)(8) and 5a(b) and Commission Regulations 1.51(a)(2), (4), (5) and (6)⁴

A. Electronic Surveillance

Since the 1997 Review, OIA’s trade practice investigations have migrated substantially from an audit-based approach, which relied on analysis of pre-formatted computer reports, to a research-based approach that integrates computer analysis customized by the investigator with floor surveillance to identify trading patterns that may indicate improper trading activity. The new approach relies substantially on the Exchange’s electronic surveillance system, the Sophisticated Market Analysis Research Technology (“SMART”) system, which was implemented in September 1996.

³ The transcript of the interview can be found in Appendix 2. OIA staff also has self-regulatory responsibility for the CBT’s affiliate exchange, the MidAmerica Commodity Exchange (“MACE”). CBT surveillance procedures described in this report apply to MACE contracts and selected MACE files were included in this review.

⁴ Section 5a(a)(8) of the Act requires each exchange to enforce all bylaws, rules, regulations, and resolutions made or issued by it or by the governing board or any committee. Section 5a(b) of the Act requires each contract market to maintain and use a system to monitor trading to detect and deter violations of the contract market’s rules committed in making the trades. Under Section 5a(b)(1), such a system must include the commitment of resources necessary for a trade monitoring system to be effective in detecting and deterring trade practice violations, including adequate staff to develop and prosecute disciplinary actions; trade practice surveillance systems capable of reviewing and used to review trade data to detect violations committed in making trades; and floor surveillance.

In addition, Commission Regulation 1.51 requires that each exchange use due diligence in maintaining a continuing program for the surveillance of trading practices on the floor of the exchange; for the investigation of customer complaints and other alleged or apparent violations of the exchange bylaws, rules, regulations, and resolutions; and for such other surveillance, record examination, and investigation as is necessary to enforce exchange bylaws, rules, regulations, and resolutions.

The Exchange uses SMART to perform surveillance of its open outcry markets. A separate automated surveillance system, discussed below, is used to monitor electronic trading on Project A. SMART's various modules allow OIA investigators to perform focused analyses of transaction patterns and trading anomalies that are initially identified by SMART and included in SMART's exceptions databases.⁵ When analyzing exceptions data, investigators can customize their analysis by tailoring search parameters to a member's individual trading characteristics, such as typical markets and positions traded, profits/losses, and trading partners. Investigators can also use the data accessible through SMART, including time and sales data, order size and type, and volume to focus surveillance on particular market circumstances, contracts, or individuals.

Project A surveillance is conducted on the Project A Surveillance System ("PASS"), which is older and less sophisticated than SMART. PASS produces nine pre-determined reports which cannot be customized by the user, and provides only limited flexibility to filter data.⁶ OIA uses PASS for surveillance of Project A trading, and also for initiating analysis of activity in markets traded side-by-side.⁷

According to OIA staff, now that the CBT-Eurex alliance has been approved by Exchange members, the Exchange plans to develop a new computer system for electronic

⁵ SMART modules include Pattern Matching, Market Profile, Trader Profile, Anomaly Detection, and WorkBench. These modules are fully described in the SMART Manual, which can be found in Appendix 3.

⁶ Project A reports include: Daily Exception Report Summary; Frontrunning Exception Report; Wash Trading Exception Report, Cross Trading Exception Report; Trading Ahead Exception Report; Side-by-Side Frontrunning Summary Report; Side-by-Side Violation Detail Report; Project A Order Report; and Project A Trade Report. A copy of the PASS Manual can be found in Appendix 4.

⁷ Side-by-side trading involves concurrent trading of a single commodity in both open outcry pit trading and on Project A electronic trading. OIA initiates surveillance of such trades by using PASS to identify concurrent trading in the two trading environments. It then analyzes the Project A trades through PASS and the open outcry trades through SMART. Currently, the following CBT markets are traded side-by-side: 30-Year U.S. Treasury Bond futures; 10-Year, 5-Year, and 2-Year U.S. Treasury Note futures; and Dow Jones Industrial Average Index futures.

surveillance of electronic trading at the CBT via the Eurex electronic trading platform.⁸ The new surveillance system, to be called eSmart, will be designed to give investigators conducting surveillance of electronic trading the same type of flexibility and customizability that SMART provides for surveillance of open outcry trading.

Electronic trading on Project A currently comprises approximately five percent of the Exchange's total trading volume. Further migration of trading to an electronic environment can be anticipated following the Exchange's implementation of the Eurex platform. The Division therefore encourages the Exchange to move forward as rapidly as possible with its planned development of eSmart.

B. Floor Surveillance

OIA staff conducts daily floor surveillance from inside the trading pits at the open and close in the CBT's larger markets. In addition, OIA assigns investigators to ongoing floor surveillance across all CBT markets, including its smaller markets, as part of its regular Trade Practice Investigation and Broker Group Investigation rotations, discussed further below. OIA staff also observe all contract expirations.

Floor surveillance responsibilities are shared by all OIA staff; no position is dedicated solely to floor surveillance. OIA documents floor surveillance activity in a log which shows the date, investigator, commodity, observation start and end times, and purpose of observation.⁹ Six trade practice investigations initiated during the target period were based primarily on floor surveillance observations.

⁸ The Exchange plans to implement adoption of the Eurex trading platform in the summer of 2000.

⁹ A copy of a sample page from the floor surveillance log can be found in Appendix 5.

C. Investigation Programs

OIA monitors daily trading activity by assigning investigators to several different types of investigations, which OIA calls investigation programs.¹⁰ Investigators working in these programs use SMART or PASS, as appropriate, to review and analyze all trading at the Exchange in order to detect various types of trading violations, as follows:

- In the Trade Practice Investigation (“TPI”) program, investigators analyze data concerning all trading at the Exchange for possible noncompetitive trading violations, such as prearranged trades, wash trades and preferential trading, and for trading ahead violations. The TPI program is the Exchange’s primary source for generating investigations.
- In the Project A Investigation (“PJA”) program, investigators review electronic trading on Project A for violations of all types.
- In the Broker Group Investigation (“BKR”) program, investigators review trading between the members of each registered broker association for preferential or prearranged trading.
- In the Assignment Trade Investigation or Taking the Other Side of an Order Investigation (“TOO”) program, investigators analyze all trades assigned to broker error accounts for compliance with CBT Rule 350.04.¹¹
- In the Time and Sales Report Investigation (“TSR”) program, investigators review non-staff error changes to Time and Sales reports for improper price changes.

1. Trade Practice Investigation Program

a. Noncompetitive Trading TPIs

OIA conducts noncompetitive trading TPIs at least once annually for each commodity. However, depending on historical trading volume data, investigators may review some commodities more often or group low-volume commodities together for review. Staff members

¹⁰ OIA procedures and reference manuals for each investigation type can be found in Appendix 6.

¹¹ CBT Rule 350.04, Errors and Mishandling of Orders, which governs assignment of trades to broker error accounts, permits a broker to assign to his error account the opposite side of a customer order which cannot be cleared due to an unresolvable outtrade.

are assigned to particular markets for four-month, commodity-specific rotations. Staff are also assigned to “float” rotations, which allow them to initiate noncompetitive TPIs in response to unusual market factors or other circumstances that merit attention. During TPI rotations, investigators combine analysis of trade data through SMART with floor surveillance to identify indications of possible noncompetitive trading.¹² When such indications are found, OIA initiates a full-scope investigation, including review of original documents and taking of statements, and formally opens a TPI.

OIA expects to open a minimum of approximately 40 full-scope noncompetitive trading TPIs each year. During the target period, OIA opened 48 noncompetitive TPIs, including ten from float rotations.¹³ In the relatively rare instances where four months of surveillance in a particular noncompetitive TPI rotation does not disclose any activity that warrants further investigation, investigators prepare a “non-initiation” memorandum at the end of the rotation, and the matter is closed.¹⁴

¹² Investigators first use SMART to do “market context development,” focusing on such factors as broker association and personal trader relationships, characteristic trading practices, proximity in the pit, market volatility, typical bid/ask spreads and trade sizes, and release of significant economic reports. They then employ the following SMART surveillance techniques: (a) “pattern match analysis,” seeking instances of wash trading, money pass, directly or indirectly crossing orders, matching orders, or taking the other side of orders, and anomalies such as larger than average personal trades or broker executions, and unusual proportions of customer versus personal volume or outrades; (b) “market-driven surveillance,” relating to significant market events, such as limit moves, significant rallies or breaks or significant reversals following such events, gap openings, and significantly wide opening or closing ranges; (c) “participant-driven surveillance,” focusing on individual market participants’ profitable trades, out-of-sequence trades, outrades, error account trades, and audit trail anomalies, or on the participant’s trading activity observed during floor surveillance; and (d) “outrade analysis” to determine whether outrades had legitimate origin and were properly reconciled.

¹³ For example, during the target period, unusual activity in the Dow Jones Industrial Average futures pit resulted in initiation of four float rotation TPIs focusing on traders in four quadrants of the pit during five volatile markets.

¹⁴ Of the approximately 40 noncompetitive TPIs conducted annually, generally no more than five result in a non-initiation memorandum. These are confined to small-contract rotations.

b. Trading Ahead TPIs

A trading ahead TPI rotation is assigned to two investigators each month. These investigators review the previous month's SMART database for potential instances of trading ahead violations. Across all markets, the investigators typically review approximately 600 exceptions (instances of trades which satisfy initial criteria for further investigation) per month from the database. Each investigator reviews a share of these exceptions and the time and sales data related to them. At the end of the month, each of the two investigators selects for full-scope investigation the 25 exceptions that he or she believes are most likely to involve possible trading ahead violations.¹⁵ This process results in 24 TPIs annually, each consisting of 25 exceptions.

2. Project A Investigation Program

OIA assigns one investigative team each quarter to its PJA program. In this program, investigators review and analyze all exception reports generated by the PASS computer system for Project A trading. These reports list transactions that may indicate possible violations such as trading ahead, front-running, wash trading, crossing orders, and taking the other side of customer orders. After reviewing these exceptions, investigators pursue further investigation in instances where trade practice violations appear likely to have occurred. They also review possible use of Project A terminals by unauthorized users,¹⁶ as well as all inquiries and referrals received by OIA concerning Project A trading activity. From all these sources, OIA opened 14 PJAs during the target period.

¹⁵ Factors in this selection include, among other things, the size of the customer order, the order type, and the financial impact of the potential violation, as they all relate to the broker's possible motive to trade ahead.

¹⁶ As part of the unauthorized user review, an investigator places telephone calls to five active login IDs each month to determine if the individual trading on the system is the individual to whom the login ID is assigned.

3. Broker Group, Assignment Trade, and Time and Sales Investigation Programs

In Broker Group Investigations (BKR), OIA reviews intra-group trading among members of broker associations for indications of possible preferential or pre-arranged trading.¹⁷

Investigators are assigned for two-month rotations, during which they must conduct at least one hour of floor surveillance each month, and review two months' trading by the broker groups under review. For review purposes, OIA divides broker associations into two groups, those with substantial numbers of intra-group trades, defined as more than five per month (the "high-volume" groups), and those with low levels of such trades, defined as five or less per month (the "low-volume" groups).¹⁸ Investigators subject all intra-group trading by each high-volume group to extensive computer surveillance and analysis through SMART. Trading within low-volume groups receives more limited surveillance, although exception reports are reviewed for all of the relatively small number of such trades. OIA opened a total of 66 BKRs during the target period.

The Assignment Trade Investigation or Taking the Other Side of an Order Investigation (TOO) program monitors trades assigned to CBT members' error accounts for indications of possible violations of CBT Rule 350.04. Investigators review exceptions data regarding such trades, and conduct quarterly TOO reviews to examine broader patterns in the use of error account assignment trades.¹⁹ OIA opened 130 TOOs during the target period.

¹⁷ These reviews enforce Exchange Rule 330.03, Broker Associations.

¹⁸ During the target period, approximately 60 broker associations had high-volume levels of intra-group trades, while approximately 60 had low-volume levels of such trades.

¹⁹ Investigators review the exception reports to verify that the assignment trade was entered into a broker's registered error account, that the trade was the result of an unresolvable outtrade, that liquidation of the trade occurred at least ten minutes or a bracket change following the original execution of the order and that the trade was assigned at the correct price.

In the Time and Sales Report Investigation (TSR) program, during each quarter investigators review changes to time and sales for improper price changes that may be affected by potential conflicts of interest or are made contrary to CBT rules.²⁰ OIA also examines any customer or member referrals concerning possible TSR anomalies. During the review period, OIA opened five TSRs.²¹

In addition to assigning investigators to these investigation programs, OIA generates investigations from complaints received from internal and external sources, including customers, members, anonymous sources, other Exchange departments, and the Commission. OIA labels such an investigation as an Inquiry (“INQ”).²²

When OIA staff has completed an investigation and prepared a final investigation report, OIA management determines whether the matter will be referred to a disciplinary committee, such as the Floor Governors Committee (“FGC”), for further action or closed. OIA tracks the disciplinary phase of each matter referred to committee in a separate Investigation (“INV”) file.

²⁰ Data reviewed includes all changes to an opening range made more than 30 minutes after the open; all changes to a closing range made more than 15 minutes after the close; all changes that affect a contract high or low and take place more than 15 minutes after the close; and all quotation changes not affecting an open, high, low or settlement price but made subsequent to the next day’s opening.

²¹ On February 23, 2000, the Exchange submitted to the Division a request to modify its BKR, TOO, and TSR programs, based on the results of a cost/benefit analysis of these programs done by the Exchange. The Exchange reported that these programs as currently constituted identified very few substantive abuses and led to very few disciplinary actions, and that continuing them in their present form would be a “highly inefficient allocation of resources.” For BKR investigations, the Exchange proposed modifying its existing program by integrating review of intra-group trading into the TPI program, where it would be included in the SMART research conducted for noncompetitive trading. The Exchange proposed shifting its TOO program to a research-based rather than audit-based approach similar to that taken in the TPI program. Although the Exchange initially proposed eliminating the TSR program because it was not cost-effective, after further consultation with the Division, the Exchange agreed to modify its TSR program to review those price changes which appear to have the greatest likelihood of involving a potential rule violation. Given the results of the Exchange’s cost/benefit analysis, the Division advised the Exchange that it has no objections to these modifications.

²² During the target period, OIA opened 33 INQs, including two based on customer complaints. For purposes of this review, INQs exclude non-trade practice issues categorized in Exchange logs as “Miscellaneous.”

D. Timeliness and Adequacy of Investigations

1. Timeliness

In the 1997 Review, the Division found that the Exchange generally did not complete investigations in a timely manner, and recommended that the Exchange must take appropriate steps to improve the timely completion of investigations.²³ In the present review, the Division found that the Exchange continued to have a problem with untimely investigations. During the target period, the Exchange had a large number of investigations open for more than one year, and in some cases in excess of two or even three years. As shown below in Figure 1, nearly half of the investigations closed during the target period (144 out of 322 investigations, or 45 percent) were open for more than a year. Of the investigations closed in less than a year, 148 of the 322 closed investigations, or 46 percent, required between five months and one year to close, while 30 of the 322 investigations, or 9 percent, were completed in four months or less.

²³ Commission Regulation 8.06 requires that an investigation be completed within four months, unless there are significant reasons to extend it further.

In this section of this review, the terms “trade practice investigation” and “investigation” refer to all investigations conducted by the Exchange in the various investigation programs discussed above, including TPI, PJA, BKR, TOO, and TSR investigations resulting from OIA surveillance activities and INQ investigations resulting from outside referral to OIA. For purposes of this review, the Division has deemed a matter to be an investigation from the time OIA assigned an investigation number to a matter under review. In analyzing the timeliness of the Exchange’s trade practice investigations, as discussed below, the Division used the committee date identified in the INV log as the date the investigative phase was closed and the disciplinary phase commenced.

Length Of Investigations Closed During Target Period

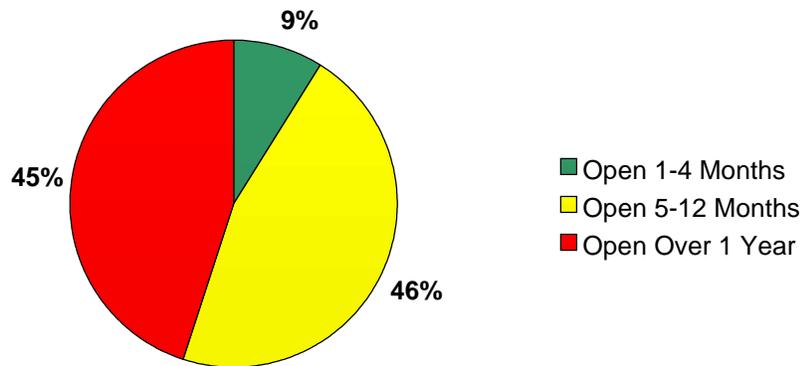


Figure 1

The investigations open more than one year included large numbers of notably untimely investigations. Thirty-seven of the 322 total investigations, or 11 percent, were open for more than a year and a half. Further, nine investigations were open for more than two years, and two were open for more than three years.

Timeliness problems were particularly prevalent with the 217 investigations already open at the beginning of the target period. During the target period, the Exchange made an effort to close those older investigations, and ten remained open at the conclusion of the target period. Of the 207 such investigations closed during the target period, 21 by referral to the FGC, 70 percent (144 investigations) were open for more than one year. Twenty-nine percent (61 investigations) were closed within five months to one year, and one percent (two investigations) were completed within four months.

The timeliness picture was somewhat improved with respect to the 323 investigations opened during the target period. One hundred fifteen, or 36 percent, of these investigations were

closed before the end of the target period, six by referral to the FGC, while 208 or 64 percent were still open when the target period ended. With respect to the 115 closed investigations, 24 percent (28 investigations) were closed within four months, while another 16 percent (37 investigations) were closed within six months. Of the 208 investigations opened during and still open at the close of the target period, more than half (107 investigations, or 51 percent) had been open for less than four months, while another 18 percent (37 investigations) had been open less than six months and 31 percent (64 investigations) had been open between six months and one year.²⁴

The Division examined 32 investigations closed during the target period that were open for more than one year, including seven of the 11 investigations open for more than two or more than three years. The Division found that four of the investigations open for more than one year involved complex fact patterns, multiple document requests, or other significant reasons to extend the investigation.²⁵ However, half of the 32 investigations were dormant for substantial periods without apparent justification.²⁶ In addition, with respect to more than half of the 11 most untimely investigations, the Division found, as it found in the 1997 Review, that undue

²⁴ As noted earlier, ten investigations opened prior to the target period remained open after its close, making a grand total of 218 investigations open at the conclusion of the target period. Shortly after the conclusion of the target period, eight of these older investigations were closed and two were sent to the FGC. The eight closed investigations ranged in age from approximately one year and one month to one year and five months; the two sent to committee had been open one year and nine months and one year and three months, respectively.

During the Division's exit conference with the Exchange, OIA staff advised the Division that as of June 15, 2000, only eight of the Exchange's ongoing investigations had been open for more than one year, the oldest of which had been open for 15 months. OIA staff stated that it was the Exchange's goal that by October 1, 2000, and thereafter, the Exchange would have no investigations open for more than 10 months.

²⁵98-TPI-10, 97-TPI-32, 97-TPI-62, 98-TPI-5.

²⁶ 96-TPI-12, 96-TPI-68, 97-TPI-53, 97-TPI-58, 97-TPI-59, 97-TPI-63, 97-TPI-65, 98-TPI-18, 97-INQ-30, 97-INQ-43, 98-INQ-7, 98-INQ-19, 97-PJA-4, 97-PJA-5, 98-PJA-2, 98-TOO-58.

delays in supervisory review were a major factor in investigation untimeliness.²⁷ Supervisory review took nearly two years in both investigations open more than three years,²⁸ and took between five and 10 months in four of the nine investigations open more than two years.²⁹

Staff departures and the relative inexperience of investigative staff also contributed to investigation tardiness. Exchange staff informed the Division that OIA experienced turn-over rates of approximately 25 percent during the target period and 37 percent during the 12 months preceding the target period.³⁰ The Exchange as a whole has an average staff turn-over rate of approximately 15 percent per year. More than half of OIA's junior investigative staff were hired during the target period or the 12 calendar months preceding it, and OIA's junior investigators typically had no prior experience in investigating commodities trading.³¹

²⁷ In the 1997 Review, the Division found that "many [investigations] were delayed because of significant delays in supervisory review . . ." *1997 Review at 44*. The Division therefore advised that OIA "should undertake a review of its internal procedures for monitoring the progress of investigations and for processing investigations through the supervisory review." *Id.* The Exchange responded that it had "recently doubled the number of supervisory staff authorized to approve cases from 3 to 6 individuals and [had] increased its number of reviewers from 6 to 9 reviewers." *CBT letter to the Division dated May 7, 1997*. The facts found in the present review make it evident that the problem of delay in supervisory review still exists. Therefore, the Division believes that the Exchange must reexamine the steps it took to address this problem, and take whatever other steps are required to eliminate delayed supervisory review of investigations.

²⁸ 96-TPI-12, 96-TPI-25.

²⁹ 96-TPI-53, 96-TPI-64, 96-TPI-68, 96-TPI-24.

³⁰ The Exchange also responded to the finding of investigation untimeliness in the 1997 Review by citing the fact that OIA experienced a greater than 20% staff turnover during the period covered by the 1997 Review. *CBT letter to the Division dated May 7, 1997*.

³¹ OIA's non-management investigative staff includes eight Senior Investigators, one Senior Trading Analyst, 13 Staff Investigators, and one Administrative Assistant. With the exception of the Senior Trading Analyst, who has more than 12 years of experience, these staff members have from four months to two and one-half years of CBT experience. Three staff members had trading floor experience prior to joining OIA, two as former traders and one as a trading desk and back office employee of a member firm. Two other staff members formerly worked as Exchange Market Report staffers and had floor experience in their market reporting duties. OIA's senior investigative staff have substantial trade practice investigation experience. The Investigations Department's Managing Director and Director each have more than 12 years of experience in various capacities at the CBT, and its three Managers have from six to ten years of experience, while its four Supervisors and one Assistant Supervisor each have approximately three to five years of experience. A copy of OIA's Investigations Position Descriptions can be found in Appendix 7.

The CBT's performance with respect to investigation timeliness constituted a material deficiency. When investigations remain open for extended periods, proof becomes problematic as memories fade and gaps in documentation become more difficult to fill. As a result, deterrence is diminished, and self-regulatory effectiveness is reduced. Notwithstanding recent improvement, the CBT needs to take prompt and effective action to bring this aspect of its program into compliance. In this regard, the Division recommends that the Exchange focus substantial attention on timely completion of investigations in order to achieve significant improvements in timeliness. In addition, the Division requests that the Exchange file a quarterly report with the Division, beginning in October 2000, that details the timeliness of investigations closed during the previous quarter.

2. Adequacy

With only two exceptions, discussed below, the Division found that the Exchange conducted thorough, well-documented investigations and made appropriate, well-founded analyses.³² Files referred to the FGC were well-documented, including pertinent underlying trading documents, summaries of witness interviews, correspondence, computer reports of trading activity, summaries of trading activity, investigation reports, and investigative and activity logs. They also included the material needed for appropriate committee deliberations, including closing memoranda describing the facts and giving staff conclusions and recommendations, and investigative packets with sufficient backup detail. Several investigations

³² To determine whether the Exchange is conducting adequate trade practice investigations, Division staff reviewed 109 of the investigations closed during the target period. The investigations reviewed were drawn from investigations across all CBT markets, and included 34 TPAs, 16 PJAs, 12 BKRAs, and 11 TOOs. They also included 36 cases referred to OIA from outside sources and classified as INQs, including 19 anonymous complaints, 12 member complaints, two customer complaints, one Commission referral, and two "other" sources.

resulted in disciplinary sanctions involving substantial fines and denial of trading floor privileges for extended periods.³³ Files closed administratively and not forwarded to committee were equally well-documented. OIA's decisions to close such files without disciplinary referral were supported by adequate analysis.

Some highly complex investigations involved analysis of a substantial amount of data over an extended period of time. Simpler, more straightforward investigations, such as those focused on a single trade, also received thorough analysis. Even in such single trade reviews, OIA generally conducted extensive interviews with not only the parties to the trade but also the traders' clerks, floor staff of the affected futures commission merchants, and other traders in the pit.

The Division found that one major reason for the Exchange's good record regarding investigation adequacy is OIA's use of SMART. The Division noted in the 1997 Review that use of SMART was likely to enhance the Exchange's trade practice surveillance program, and this hope has been fulfilled. The new system and its flexible, interactive interface have given OIA pattern analysis capabilities that allow investigators to make independent judgments concerning the focus and scope of investigations. The high quality of the investigative leads developed by using SMART has enhanced OIA's final investigative product. Many of the Exchange's most substantive trade practice investigations were generated from surveillance and trade data analysis through SMART.

³³ The investigations reviewed by the Division included all 27 investigations referred to the FGC for disciplinary proceedings during the target period. These disciplinary cases involved such violations as noncompetitive trading, trading ahead of customer orders, improper use of error accounts, improper outrade resolution, improper settlement of option prices, and improper trade practices on the Project A electronic trading system. For a discussion of the CBT's disciplinary program, see pp. 19-27.

Although the Exchange conducts adequate investigations, two investigations reviewed by the Division involved investigation aspects which the Exchange should improve in future, similar cases. First, in case 99-INV-11, OIA determined through extensive analysis and interviews that on several occasions over a 15-day period in March 1999 the Vice-Chairman of the Wheat Options Pit Committee settled wheat option prices out of line with their fair market value, apparently in order to enhance the equity in his personal trading account with regard to several hundred option contracts. To do this, the Vice-Chairman overrode the Exchange's automated Option Settlement Verification Program ("OSVP"), which identifies discrepancies between the pit committee's settlement recommendations and theoretical parity. Discrepancies are supposed to be resolved by the pit committee representative either modifying the settlement price to conform to the parameters given by the OSVP or justifying why the option should settle outside the parameters.³⁴ In OIA interviews, the Vice-Chairman admitted that he had marked settlement prices to benefit his position, but claimed that this practice occurs routinely across all markets.³⁵

OIA did not pursue this serious allegation. The Division believes that OIA should have, at a minimum, examined a sampling of other markets' settlements and interviewed pit committee members. If the allegation were true, a threat to the integrity of the price discovery function could exist. Therefore, the Division requests that OIA investigate the allegation that this is an ongoing practice.

³⁴ Pit committee option settlement procedures are addressed in an Exchange Notice dated August 19, 1998, which can be found in Appendix 8.

³⁵ OIA forwarded this matter to the FGC for consideration, and the disciplinary phase of the case is discussed below at p. 21.

Second, in case 97-INV-3 the FGC charged two members with noncompetitive and prearranged trading violations, which were serious enough to result in severe disciplinary penalties.³⁶ OIA did not detect, however, that one of the members apparently continued similar illegal trading activity during part of the period of no less than two years and two months that the matter was before the FGC.³⁷ The Division identified these apparent, continuing violations in the course of routine oversight surveillance.

In this regard, the Division believes it would be appropriate practice for the CBT and other exchanges not currently doing so to take cognizance of the trading activity of those members whose cases are referred to disciplinary committees. The facts which led exchange enforcement officials to bring charges against such members also constitute reasonable grounds to suspect that they might engage in further illegal trading.

E. Conclusions and Recommendations

The Division found that the Exchange maintains an adequate trade practice surveillance program, including electronic surveillance, floor surveillance, and appropriate programs for routine development of trade practice investigations. The Division found that trade practice investigations were thorough, well analyzed, and adequately supported by documentation. The Exchange demonstrated innovation and initiative in its detection and prosecution of trade practice abuses. Use of SMART has improved OIA's ability to analyze open outcry trades, and the Exchange plans to move to a similar surveillance system for electronic trades after its

³⁶ One trader was fined \$100,000 (the largest fine imposed during the target period) and suspended for 30 days, while the other was fined \$20,000 and suspended for 20 days.

³⁷ The untimely manner in which this case was moved through the Exchange's disciplinary process is discussed at pp. 25-26.

alliance with Eurex is implemented. Further, investigations initiated internally by the Exchange are resulting in imposition of significant disciplinary sanctions.

Based on issues arising in two investigations, however, the Division believes the Exchange should further improve its investigations by widening their scope when potentially serious allegations of wrongdoing are made, and should also take cognizance of the trading activity of members whose cases are referred to disciplinary committees.

The Exchange's performance with respect to investigation timeliness constituted a material deficiency. The substantial untimeliness of almost half of the investigations included in the target period and the large number of investigations open beyond two years give the Division particular concern in this area. When investigations remain open for such extended periods, memories fade, proof becomes problematic, deterrence is diminished, and self-regulatory effectiveness is reduced. Notwithstanding recent improvement, the CBT needs to take prompt and effective action to bring this aspect of its program into compliance.

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

- Focus substantial attention on timely completion of investigations in order to achieve significant improvements in timeliness. Additionally, the CBT must file a quarterly report with the Division, beginning in October 2000, that details the timeliness of investigations closed during the previous quarter.
- Widen investigations appropriately when potentially serious allegations of wrongdoing are made.
- Take cognizance of the trading activity of members whose cases are referred to disciplinary committees.

III. DISCIPLINARY PROGRAM – Section 5a(b) and Commission Regulation 1.51(a)(7)³⁸

A. Sanctions

1. Sanctions Imposed

During the target period, 42 cases were presented to the FGC for disciplinary action.³⁹

Forty-one of these cases involved substantive trade practice violations, including, among others, failing to execute transactions competitively by open outcry; prearranged trading; accommodation trading; trading ahead of customer orders; taking the other side of customer orders; mishandling of orders; contravention of Project A rules; and registered floor clerks holding interests in futures accounts which contained positions in contracts traded on the Exchange.

Twenty-nine of the 42 cases brought before the FGC were closed during the target period. In 26 of these cases, the FGC imposed sanctions against a total of 47 separate individuals or entities. In two cases, the FGC deemed reminder letters sufficient and imposed no sanctions; and in one case it took no action because it found no rule violation. Thirteen of the 42 disciplinary actions included in the target period remained open as of the end of the period.

³⁸ Under Section 5a(b) of the Act, an exchange's trade monitoring system must include appropriate disciplinary actions and meaningful penalties against violators. In addition, Commission Regulation 1.51(a)(7) requires that each exchange use due diligence in maintaining a continuing affirmative action program that results in prompt, effective disciplinary action for violations of exchange rules. When reviewing disciplinary programs, the Division considers, among other factors, the support for findings made in disciplinary actions, the adequacy of sanctions imposed, and the timeliness of procedures. The Division also assesses compliance with Commission Regulations 8.09 and 8.17, which require, respectively, that disciplinary committees review investigation reports in a timely manner and issue either a notice of charge or a written decision stating the reasons why no further action will be taken, and that hearings be convened promptly after reasonable notice.

³⁹ CBT Rule 543.00(d) gives the FGC authority to ensure that members and member firms and their employees comply with Exchange rules. Under the rule, the FGC can bring formal charges and impose preliminary penalties including a reprimand, a cease and desist order, a fine not to exceed \$25,000 for each such violation, and/or *(continued . . .)*

No disciplinary hearings were held during the target period; all of the sanctions imposed resulted from settlement agreements between the FGC and the parties involved. The monetary sanctions levied totaled \$328,000, and ranged from \$1,000 to \$100,000.⁴⁰ The FGC also suspended 18 individuals, 16 of whom were also fined, for a total of 1,200 days. The duration of these suspensions ranged from five to 365 business days. No members were expelled. Seventeen individuals or entities were reprimanded.⁴¹ The FGC ordered two members who had not made restitution to customers during the investigation phase of their cases to pay restitution, in amounts totaling \$1,162.50. In addition, investigated members paid \$39,114.50 in adjustments to customers in a total of 30 investigations which OIA closed administratively and did not present to the FGC.⁴²

2. Adequacy of Sanctions

The Division believes that in most of the cases brought before the FGC during the target period, the Exchange imposed adequate sanctions. In addition to imposing substantial fines, the

restitution. It can also impose preliminary denial of the privileges of the trading floor or suspend Exchange membership for up to 90 business days for each such violation.

⁴⁰ For example, noncompetitive and prearranged trading violations drew monetary sanctions totaling \$120,000 and suspensions totaling 50 days in one case, while in another case they drew monetary sanctions totaling \$45,000 and suspensions totaling 200 days. A case involving destruction of orders resulted in a monetary sanction of \$15,000 and suspension for 180 days. A case involving changing prices resulted in monetary sanctions totaling \$17,500 and suspensions totaling 15 days.

All fines imposed during the target period have been paid, with the sole exception of a \$5,000 fine agreed to by a trader who is no longer an Exchange member.

⁴¹ During the target period, the FGC also issued 12 reminder letters in five separate matters, including three cases in which some parties received reminders but other parties received sanctions, and two cases where only reminders and no sanctions were issued.

⁴² More than 75 percent of these adjustments were for less than \$725. OIA informed the Division that in cases where the evidence indicates an error or oversight rather than deliberate wrongdoing, and a first-time offense is involved, OIA frequently gives the member involved the choice of making all injured customers whole or having the matter considered by the FGC. Adjustments agreed to by members involved in cases closed administratively rather than referred to the FGC do not constitute formal sanctions. The Division reviewed four of these investigations and in all instances agreed with OIA's decision to close them administratively.

Exchange made extensive and commendable use of suspension from the trading floor as a sanction.

The Division does have concerns, however, regarding the appropriateness of the sanctions imposed in two cases. First, the Division believes that the penalty assessed in 99-INV-11, a written reprimand, was not commensurate with the seriousness of the violation. As noted earlier, OIA determined through extensive analysis and interviews that on several occasions over a 15-day period the Vice-Chairman of the Wheat Options Pit Committee overrode the Exchange's automated Option Settlement Verification Program to settle wheat option prices out of line with their fair market value.⁴³ By doing so, the Vice-Chairman apparently used his position to enhance the equity in his personal trading account with regard to several hundred option contracts. The Division believes this was a serious violation, which may have implicated the market's price discovery function and pay and collect settlements. Therefore, the Division believes that a monetary penalty and/or suspension from the trading floor were warranted in this situation.

Second, in case 98-INV-20, two Commodity Option Market ("COM") members were sanctioned for operating outside the privileges of their options market memberships by giving customers futures-related advice not related to option strategies.⁴⁴ One member was fined \$5,000, in part because he had some supervisory responsibility. During the investigation, OIA discovered that the other member also had disclosed to another customer the stop prices on two resting orders. This member was given a reminder letter regarding servicing business beyond the

⁴³ A problem with the adequacy of this investigation is discussed above at p. 16.

⁴⁴ CBT Rule 293.00, COM Membership Interests, provides in pertinent part that "the holder of a COM Membership Interest may communicate from the Floor of the Exchange with persons not on the Floor of the Exchange in the same manner as may full members, but only with respect to options contracts traded in the COM."

scope of his membership, and was fined \$2,500 for disclosing orders. While the Division believes the manner in which the FGC settled the initial charges against the members and their firm for servicing business beyond the scope of membership was appropriate, it believes the settlement with the member who disclosed orders resulted in inadequate sanctions. By disclosing order information, that member jeopardized the integrity of the market and disregarded his duty to his customers. The Division believes that a \$2,500 fine does not adequately address the seriousness of this violation.⁴⁵

3. Matters Not Referred To A Disciplinary Committee

The Division also has concerns about the Exchange's disciplinary response to one Project A matter and to possible violations of CBT Rule 350.04, Errors and Mishandling of Orders. In these instances, OIA issued reminder letters and did not refer the investigations to the FGC for consideration of charges, even though what appear to be serious substantive violations were involved.

In investigation number 97-PJA-05, two members admitted to trading routinely on Project A Two-Year Treasury Notes opposite their own bids or offers. OIA identified 121 of these wash trade instances between June 1997 and March 1998 for one trader and 23 instances in February 1998 for the other trader. OIA closed the case administratively, without a disciplinary referral, and issued reminder letters to both traders regarding Exchange Rule 501.00, Fictitious Transactions. The Division believes that 121, or even 23, instances of wash trading present a significant pattern of prohibited trading activity, which at a minimum should have been referred to the FGC for review. OIA's administrative settlement of this matter unduly minimized the seriousness of possible wash trading violations.

⁴⁵ See Exchange Rule 350.05(d) regarding disclosing orders.

Similarly, in its enforcement of CBT Rule 350.04 on Errors and Mishandling of Orders, OIA did not refer repeat offenders to a disciplinary committee in a number of instances.⁴⁶ During the 12-month target period, 43 brokers and seven firms received more than one reminder letter from the Exchange regarding violations of this rule. One broker and one firm each received no less than four such reminder letters, while seven brokers received three, and 35 brokers and six firms each received two. The Division believes that members or member firms who violate substantive rules which address potential customer fraud, such as Rule 350.04, should not be issued more than one reminder letter in a 12-month period, absent mitigating circumstances. Subsequent infractions of such rules within a year generally should be referred to the appropriate disciplinary committee for consideration of charges and appropriate penalties.

4. Misunderstandings Regarding Electronic Trading Rules

Finally, the Division found in reviewing the adequacy of sanctions that six of the seven disciplinary cases involving Project A demonstrated a different problem: an apparent pattern of misunderstanding or confusion concerning electronic trading rules on the part of members and member firms. In three cases involving trade entry by terminal operators other than the operator logged on to the system, the members or firms involved stated that they were either unaware that login ID abuse was occurring or unaware that it was barred by Project A rules.⁴⁷ In one of these cases, the member whose login ID was being improperly used by others stated that he knew that this was a violation and knew that it was occurring, but believed that this practice was necessary

⁴⁶ Rule 350.04 provides in pertinent part that: "If after the close of a commodity's day and/or evening trading session a floor broker discovers that all or some portion of a customer order was executed but cannot be cleared, the opposite side of the uncleared portion may be assigned to the floor broker's error account and the customer shall be assigned the trade at the execution price."

⁴⁷ 98-INV-12, 98-INV-13, 98-INV-17. See CBT Project A Rules 9B11, Order Entry, and 9B15, Misuse of Project A.

to accomplish the firm's business.⁴⁸ In two cases where non-member terminal operators entered discretionary trades, members or firms involved stated that they did not know this practice was contrary to Project A rules.⁴⁹ In another case, a terminal operator who had made a non-competitive trade to rectify an error also stated that he did not know this practice was contrary to Project A rules.⁵⁰

Given the increasing growth of electronic trading at the CBT, it is essential for Exchange members to be familiar with and understand the Exchange's electronic trading rules, whether for Project A or the new Eurex platform. Therefore, the Division believes the Exchange should take appropriate steps to address this apparent pattern of misunderstanding and confusion regarding electronic trading rules, in part by issuing pertinent reminders to all members and member firms.

B. Timeliness of Disciplinary Procedures

The Division found that the FGC generally reviewed investigation reports promptly after receiving them.⁵¹ In most cases, the FGC met the 30-day deadline for preliminary

⁴⁸ 98-INV-12.

⁴⁹ 98-INV-19 and 98-INV-24.

⁵⁰ 98-INV-22. *See* CBT Project A Rules 9B15, Misuse of Project A, and 9B16, Trading Against Customers' Orders Prohibited.

⁵¹ In accordance with Commission Regulation 8.09, CBT Rule 540.01 requires that within 30 days after receipt of a completed investigation report, the committee must determine that a reasonable basis for finding a violation does or does not exist, and direct service of a notice of charges in cases where a reasonable basis is found.

Commission Regulation 8.17 authorizes an exchange to permit a member charged in a disciplinary case to submit a written settlement offer at any time after the investigation report is completed. If an offer of settlement is accepted by the disciplinary committee, Regulation 8.17 requires that the committee issue a written decision specifying the rule violations involved and all penalties imposed. If a charged member requests a hearing as provided in Commission Regulation 8.15, the exchange disciplinary committee is required by Commission Regulation 8.17 to convene the hearing promptly after reasonable notice to the charged member, and required by Commission Regulation 8.18 to render a written decision promptly following the hearing. Under Regulation 8.18, such written decisions must include: the notice of charges; the answer of the charged party; a brief summary of the evidence produced at the hearing or an incorporated copy of the investigative report; a statement of findings and conclusions with respect to each charge; and a declaration of any penalty imposed.

determinations, by acting within that period to issue preliminary charges, send reminder letters, or determine that formal charges were unwarranted.

The Division also found that the Exchange generally disposed of the disciplinary cases included in the target period in a timely manner. Of the 29 cases closed during the target period, 17 cases, or close to two-thirds, were concluded by settlement within a one to five month time period. The 12 remaining cases closed during the target period were of a more complex nature, and involved extensive settlement negotiations, multiple parties, or other reasons requiring longer periods of time for resolution. Ten of these cases were settled within six to 11 months from the time they were sent to FGC.⁵²

The Division notes, however, the delayed disposition of the remaining two cases, which were closed during the target period after remaining open for 26 months and 19 months, respectively.⁵³ Resolution of these cases was extremely untimely. Sanctions were not imposed in 97-INV-3 until more than four years after the misconduct occurred. While the imposed sanctions appear appropriate, this does not relieve the effect of their untimeliness.⁵⁴ Such delay not only weakens the deterrent effect of sanctions, but also leaves a window open for possible additional wrongdoing, which in this instance may have occurred. As noted earlier, Division

⁵² The Division also identified a trend during the target period toward improved timeliness in disposing of disciplinary cases. The two cases open for more than one year were the earliest cases falling within the target period, having been opened in 1997. None of the 16 cases commenced in 1998 was open for more than one year: six took between six and 11 months to resolve; nine were closed within six months; and one remained open at the end of the target period, having been open more than nine months. Twelve of the 22 disciplinary cases commenced during 1999 were resolved by the end of the target period, and all but one of these were resolved within five months, while the remaining one, the earliest case opened in 1999, was resolved in six months. Ten cases commenced in 1999 during the target period remained open at the end of the target period. Four of these had been open for more than four months, one for more than three months, one for more than two months, two for more than a month, and two for less than a month.

⁵³ 97-INV-3 and 97-INV-17.

⁵⁴ One of the members charged in 97-INV-3 was fined \$100,000, the largest monetary sanction assessed during the target period, and was suspended for 30 days. The other member was fined \$20,000, and suspended for 20 days.

staff detected during oversight surveillance that in December 1998, while case 97-INV-3 was before the FGC, one of the charged members may have engaged in additional illegal trading activity of the same type involving the same futures contract.

Exchange staff informed Division staff that the reason for the untimely resolution of both cases was delaying tactics employed by a single attorney who represented the members charged in both cases. The Division does not believe that this justifies the extended delays which occurred. The Exchange should take appropriate steps to deal effectively in future cases with all individuals who employ similar tactics, in order to ensure that such tactics are not allowed to impede the timeliness and deterrent effect of Exchange disciplinary actions.

The Division's review of the target period disciplinary cases indicates that, with the exception of the two 1997 cases discussed above, all of the cases had been open for less than one year. Exchange staff informed the Division that this is the first time that the Exchange has achieved a one-year disciplinary case timeliness record. The Division commends the Exchange for this accomplishment and for the trend toward greater timeliness in the disciplinary process.

C. Conclusions and Recommendations

In most of the cases brought before the FCG during the target period, the Exchange imposed adequate sanctions. In addition to imposing substantial fines, the Exchange made extensive and commendable use of suspension from the trading floor as a sanction.

The FGC generally completed initial reviews of investigation reports and issued preliminary charges on a timely basis.

However, the Division identified two areas in which the Exchange's disciplinary response was insufficient. First, the FGC's reprimand of a Pit Committee Vice-Chairman for settling option prices out of line to enhance his own positions, and its settlement for a \$2,500 fine against a member who had disclosed order information, did not reflect the seriousness of these violations. Second, OIA's issuance of staff reminder letters for multiple violations of Exchange Rule 350.04 is similarly insufficient.

Finally, the Division found that the Project A disciplinary cases brought before the FGC demonstrated a pattern of misunderstanding and confusion among Exchange members regarding the Exchange's electronic trading rules, which the Exchange should take appropriate steps to address.

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

- Issue meaningful sanctions, including appropriate fines and/or suspension from trading, where members improperly change settlement prices or disclose orders.
- Refer cases of multiple instances of violations relating to errors and mishandling of orders, absent mitigating circumstances, to the appropriate disciplinary committee for consideration of sanctions, rather than issuing repeated reminder letters.
- Take appropriate steps, including issuance of notices to members, to ensure that all members and their employees understand Exchange rules relating to electronic trading.