

For Public Release

**RULE ENFORCEMENT REVIEW
OF THE MARKET SURVEILLANCE PROGRAM
AT THE CHICAGO BOARD OF TRADE**



**Division of Market Oversight
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RULE ENFORCEMENT REVIEW OF THE MARKET SURVEILLANCE PROGRAM AT THE CHICAGO BOARD OF TRADE

I. INTRODUCTION

The Division of Market Oversight (“DMO” or “Division”) has completed a rule enforcement review (“RER”) of the market surveillance program of the Chicago Board of Trade (“CBOT” or “Exchange”) for compliance with applicable core principles under Section 5(d) of the Commodity Exchange Act (“Act”), as amended by the Commodity Futures Modernization Act of 2000, and Part 38 of the Commission’s regulations. The review covers the target period of October 1, 2005, through September 30, 2006 (“target period”).¹

The review focuses on the two core principles that relate to an exchange’s market surveillance program. Core Principle 4, *Monitoring of Trading*, relates to an exchange’s program to prevent manipulation, price distortion, and disruptions of the delivery or cash settlement process, and Core Principle 5, *Position Limitations or Accountability*, relates to an exchange’s program for enforcing its speculative position limits and position accountability rules. Appendix B to Part 38 provides acceptable practices for demonstrating compliance with Core Principles 4 and 5.

For purposes of this review, DMO staff interviewed officials and staff from the

¹ Rule enforcement reviews prepared by DMO are intended to present an analysis of an exchange’s overall compliance capabilities for the period under review. Such reviews deal only with programs directly addressed in the review and do not assess all programs. DMO’s analyses, conclusions, and recommendations are based, in large part, upon staff’s evaluation of a sample of investigation and disciplinary case files, and other exchange documents.

This evaluation process is not designed to uncover all instances in which an exchange does not address effectively all exchange rule violations or other deficiencies. Neither is the 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.

Exchange's Market Surveillance Department ("MSD").² DMO also reviewed numerous documents used by MSD in carrying out the Exchange's routine market surveillance responsibilities. These documents included, among other things, the following:

- computer reports generated by the Exchange's automated surveillance systems and other documents used in market surveillance and speculative limit and position accountability enforcement;
- files and records concerning contract expirations, speculative limit and position accountability enforcement, and speculative limit exemptions;
- market surveillance inquiry, investigation, and disciplinary action files for cases closed or conducted during the target period;
- the Exchange's market surveillance procedures manuals and guidelines; and
- minutes of all Business Conduct Committee ("BCC") meetings held during the target period.

The Division provided the Exchange an opportunity to review and comment on a draft of this report on October 4, 2007. On October 9, 2007, Division staff conducted an exit conference with Exchange officials to discuss the report's findings and recommendations.

II. SUMMARY OF FINDINGS

Findings

Market Surveillance Staff and Routine Surveillance

- MSD's staffing level is adequate. MSD is overseen by the Vice President of the Office of Investigations and Audits ("OIA"). The Managing Director leads a staff of 10 individuals whose responsibilities include the oversight of all market surveillance functions: contract surveillance; administration of the hedge exemption process; large trader and open interest reporting; speculative position limit monitoring program; administration of the exchange of futures for related positions program; inspection of regular facilities; monitoring of collateral; and analysis and posting of information

² A copy of the December 15, 2006 transcript of those interviews can be found in Appendix 1.

pertaining to deliverable supply in the grain market.³

- MSD's routine surveillance includes daily monitoring of futures and cash market prices, market news, volume, open interest, deliveries, and clearing member, large trader and options positions relating to each Exchange contract. MSD also conducts daily review of position exception reports and reviews price movements to identify unusual or abnormal trading activity. In addition, MSD is in regular contact with market participants.

Surveillance of Expiring Contracts

- Surveillance of expiring contracts is heightened well in advance of the last trading day, focusing on position concentrations, large trader positions, deliverable supplies, and the relationship between open interest and deliverable supplies. Expiration Summary Files maintained for contract expirations are well documented and reflected the surveillance activities conducted.
- The July 2006 Wheat contract was the only non-routine expiration during the target period. Changes to deliverable grade wheat specifications effective with the September 2006 contract resulted in an extremely wide July 2006-September 2006 price spread. One grain warehouse was alleged to have charged an above-market premium for upgrading existing warehouse receipts to comply with new contract specifications. MSD maintained close observation of the market and was in daily contact with the warehouse. The contract expired in an orderly manner, despite the increased spread. MSD referred the matter to the BCC and the warehouse was fined \$25,000 for providing deficient information to the market regarding its upgrade fees.

Large Trader Reporting

- CBOT's surveillance data systems, including its large trader reporting system and large trader aggregation program, make relevant data and exception reports readily available to and sortable by MSD analysts. Analysts can retrieve reportable position and account identifying information by specifically selected criteria. These systems give MSD routine access to market participants' positions.

³ On July 12, 2007, Chicago Mercantile Exchange ("CME") Holdings Inc. and CBOT Holdings Inc. completed a merger at the holding company level and the combined company is now called CME Group Inc. CME and CBOT continue to maintain separate designated contract market ("DCM") status and each exchange remains responsible for its individual self-regulatory responsibilities. However, pursuant to a Regulatory Services Agreement, CME has agreed to provide to and on behalf of CBOT, all regulatory services that are required for CBOT to maintain its DCM status by remaining in compliance with the Act and the CFTC's regulations. CBOT and CME are in the early process of merging staff from CBOT's OIA, including MSD, into CME's Market Regulation Department. Based on preliminary conversations with senior Market Regulation officials, it appears that the vast majority of MSD staff will continue to perform their market surveillance functions and that surveillance of CBOT's contracts will continue in a manner similar to how it was performed during the target period.

Enforcement of Speculative Position Limits, Hedge Exemptions, and Position Accountability

- MSD analysts use the Over the Limit (“OTL”) report to detect potential speculative position limit violations and for general market surveillance purposes. The OTL report incorporates large trader data, speculative position limit and hedge exemption information, and identifies any accounts that may be holding positions in excess of speculative position limits.
- MSD closed 46 investigations related to potential position limit violations during the target period. The files reviewed by the Division contained complete documentation, including investigative summary memoranda; reference to appropriate CBOT rules; copies of correspondence (including any letters issued by the CFTC); and activity logs and disciplinary outcomes, if any.
- MSD had 122 position limit exemptions on file during the target period. The files reviewed by the Division contained appropriate documentation, including MSD reviews of calculations of the appropriateness of all hedge positions. Exemptions were approved based only on appropriate hedge amounts.
- The Exchange has appropriate procedures to monitor position accountability. Because MSD routinely contacts market participants and collects data regarding trading strategies and trading and cash market positions, MSD rarely needs to invoke CBOT’s position accountability rules.

Monitoring of Exchanges of Futures for Physicals (“EFPs”), Exchanges of Futures for Swaps (“EFSs”), and Exchange for Risk (“EFRs”)

- The Exchange routinely monitors exchange of futures for related positions (“EFRPs”), which include EFPs, EFSs, and EFRs, to ensure that these transactions comply with Exchange rules. Since the Division’s last review of CBOT’s market surveillance program in 2001 (“2001 Review”), MSD has implemented a new application that allows complex search capabilities, pattern match detection, identification of anomalies, maintenance of profiles, and generation of statistical data for EFRPs. This has resulted in more efficient identification of potential EFRP rule violations meriting further review.
- The Exchange closed 55 EFRP investigations during the target period. The investigations reviewed by the Division were thorough, well-documented, and completed in a timely manner.

Miscellaneous MSD Investigations

- MSD closed 11 investigations related to the delivery process and the Exchange’s recordkeeping and reporting requirements during the target period. These investigations resulted in one verbal MSD warning, three warning letters, and the imposition of five

findings. All of the investigations were thorough, well-documented, and completed in a timely manner.

Conclusion

- The Exchange maintains an effective and comprehensive market surveillance program.

III. SURVEILLANCE OF MARKET ACTIVITY

Core Principle 4 – Monitoring of Trading:

The board of trade shall monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.

Core Principle 5 – Position Limitations or Accountability:

To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary and appropriate.

Pursuant to the acceptable practices set forth in Appendix B to Part 38 of the Commission's regulations, an acceptable market surveillance program should regularly collect and evaluate market data to determine whether markets are responding to the forces of supply and demand. An exchange also should have routine access to the positions and trading of its market participants. To diminish potential expiration problems that may arise from excessively large positions, an exchange may need to establish speculative limits for some commodities. Such position limit rules may provide for hedge or other exemptions, and the limits may be set differently by markets, delivery months, or time periods. Spot month limits should be adopted 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.

Position limits are not necessary for markets where the threat of excessive speculation or manipulation is very low. For some contracts, such as financial instruments, an exchange may provide for position accountability in lieu of position limits. An exchange that trades several

products with a large number of traders should have an automated large trader reporting system that is used daily to enforce compliance with position limit rules.

A. *Market Surveillance Staff and Overview of Routine Surveillance*

MSD is part of the Exchange's OIA and is responsible for administering the Exchange's market surveillance program. During the target period, there were ten staff members performing routine market surveillance functions, an increase from the staff level of six during the target period for the Division's 2001 Review.

MSD staff has extensive industry and Exchange experience, ranging from one to 26 years. MSD is led by a Managing Director, who has been with the Exchange since 1986. The Managing Director reports to the Vice President of OIA, who has been with the Exchange since 1988. The Managing Director is responsible for overseeing both MSD and the Registrar's office, which certifies and monitors supplies deliverable against CBOT contracts. He also serves as the staff liaison to the BCC,⁴ the Common Clearing Link Steering Committee,⁵ and the FIA Delivery Subcommittee.

MSD's staff consists of a Senior Manager (hired in 1989), two Supervisors (hired in 1990 and 2001), one Assistant Supervisor (hired in 2002), two Senior Market Analysts (both hired in 2003), three Market Analysts (two hired in 2005 and one hired in 2006), and one Assistant Market Analyst (hired in 1980).⁶

⁴ The BCC's responsibilities include, among other things, ensuring that contracts expire in an orderly fashion and providing for the prevention of market manipulation and cornering. The BCC has the authority to impose penalties, including levying fines and suspending trading privileges.

⁵ On April 16, 2003, the CBOT and CME signed an agreement for a Common Clearing Link, in which CME Clearing provides clearing services and processing for the CBOT.

⁶ "Senior" denotes a more experienced staff member. The natural progression from analyst to senior analyst is typically 15-18 months.

MSD is structured to ensure a well-rounded staff capable of performing several tasks in case of employee turnover. This is accomplished through cross training staff in contract surveillance; monitoring and reviewing EFRPs, speculative position limits, hedge exemptions; and conducting inspections for the Registrar's office. MSD staff members are assigned to monitor particular contracts, with more experienced staff generally assigned the higher-volume contracts, such as Treasury Bonds, Ten-Year Treasury Notes, Corn, and Soybeans. Rotation of contracts is infrequent in order to allow staff time to build contract-specific knowledge and foster ongoing relationships with market participants. Conversations with market participants are electronically logged and staff are encouraged to review the logs for all CBOT contracts to gain overall knowledge of the markets.

Professional growth is supported through on-the-job experience, Exchange-offered classes that are available each quarter, and graduate-level courses outside of the Exchange. All staff compose informal weekly market surveillance reports that are shared throughout the department. In addition, MSD staff work closely with the Exchange's product development staff to ensure an understanding of new contracts.

MSD's routine surveillance activities include daily monitoring of prices, volume, and open interest to detect potential price distortions and market congestion. Staff also monitors daily price movements and spread relationships, market news, deliveries, physical supplies, and other factors that could affect CBOT markets. Clearing member and large trader positions are also monitored daily to ensure compliance with speculative and hedge exemption position limits. MSD regularly contacts trade sources and large market participants to keep informed of cash market developments and delivery intentions.

The Division finds that MSD's staffing level is adequate.

B. Surveillance of Expiring Contracts

MSD staff monitor daily activity in all futures and options markets to detect and prevent price manipulation. As expiration approaches, staff focus on any anomalies in trading patterns and market activity compared to prior expirations.⁷ Analysts review daily reports of the activities of large traders, cash and futures prices, spread and basis relationships, size and ownership of deliverable supply for physical delivery contracts, large trader positions relative to the total open interest, and other market factors. MSD routinely gathers information about cash market prices and supplies, transportation rates, repo rates, cost of carry, and other factors that may affect an orderly liquidation. Analysts frequently contact market participants to obtain current information on their positions, delivery intentions, and strategies. MSD staff analyze unusual trader activities, short supply indications, or abnormal price relationships among cash, futures, and options markets. Analysts also work with their CFTC counterparts and other government agencies to share information and to advise market participants of their responsibilities to assure an orderly liquidation. In addition, MSD staff routinely review significant market developments and conduct surveillance briefings with supervisors and/or the BCC, as needed.

As contracts approach expiration, MSD focuses its attention on daily large trader reports, position concentrations, and volume and open interest distribution among market participants. Surveillance is continuous throughout the life of each contract, but intensifies on the next deferred contract month prior to the roll forward and, specifically, on the spot month. Analysts closely monitor cash and futures prices, spread and basis relationships, or unusual market circumstances that may raise the potential for a liquidation problem.

⁷ Specific market conditions, rather than a prescribed time frame, dictate when heightened surveillance of expiring contracts occurs. However, surveillance generally intensifies as market participants roll their positions forward, at least a month before expiration.

In addition, MSD staff routinely compile Expiration Summary Files (“ESFs”) for each expiring contract. ESFs typically contain documentation of surveillance activities during the last days of a contract’s trading, including price, volume and open interest information, and large trader and clearing member position data. ESFs also typically include analyses and comparisons of futures and cash prices, spread relationships, deliverable supply, repo rates, barge freight and train rates, receipts and shipments, delivery notices and warehouse registrations, as well as logs documenting staff conversations with market participants and CFTC staff.

Division staff examined 17 ESFs prepared by MSD during the target period. These included eight agricultural, five financial, and four metal ESFs.⁸ ESFs for physically delivered agricultural contracts contained data primarily focusing on delivery, including closing summary memoranda that provided details regarding accumulation of deliverable supplies, the daily rate of contract liquidation, delivery intentions and strategies, and the number of contracts open on the last day of trading.

The ESFs reviewed for cash-settled financial contracts reflected MSD’s focus on monitoring futures price movements, changes in spread relationships, and large trader futures and cash positions. These ESFs also included price data, volume and open interest summary information for the last day of trading, and reportable position and clearing member position data on the last day of trading. It was also evident that MSD evaluated cash prices to assure that they were based on reliable price series reflecting the underlying cash market.⁹ For both physically delivered and cash settled contracts, interviews of market participants provided information

⁸ The ESFs examined were prepared for the following contracts: December 2005 Oats, September 2006 Corn, June 2006 Ethanol, September 2006 Rice, July 2006 Wheat, July 2006 Soy Complex (Soybeans, Soybean Meal, Soybean Oil), September 2006 Treasury Bonds, March 2006 10-Year Treasury Notes, December 2005 5-Year Treasury Notes, September 2006 2-Year Treasury Notes, September 2005 Dow Jones Industrial Average, May 2006 Gold, May 2006 Silver, June 2006 Gold and June 2006 Silver.

⁹ Information concerning the underlying cash markets for financial products was compiled from news services, the internet, and other sources.

regarding delivery intentions and strategies, and other information relevant for assuring orderly expirations.

The July 2006 Wheat contract was the only non-routine expiration included in MSD's ESFs during the target period.¹⁰ The ESF for that contract expiration is illustrative of MSD's intensified, coordinated surveillance when there is a threat of manipulation or disorderly trading. In the aftermath of changes to the deliverable grade specifications of the Wheat contract, the July-September spread became extremely erratic. Beginning with the September 2006 contract, wheat deliverable against the contract was allowed to contain four parts per million vomitoxin. The July 2006 contract was the last contract to allow wheat containing five parts per million vomitoxin. Any party holding receipts and wanting to deliver them against the September 2006 contract needed to have them upgraded to the higher standard by the issuer of those receipts.¹¹

MSD closely monitored the expiration, quickly gathering and analyzing price information to assess changing market conditions. As expiration of the July 2006 contract approached, the July-September spread became volatile as the market tried to price in the upgrade costs. Two warehouse facilities had issued receipts and consequently market participants sought to negotiate upgrades with those facilities. Early in the delivery month, one of the warehouse facilities acted quickly and determined a price of 6.5-7.5 cents per bushel to upgrade. The other facility was more evasive with its pricing information, and finally determined a price of 20 cents per bushel for the upgrade. As a result, the July-September spread widened to full carry plus 20 cents at expiration.

¹⁰ This was also the only non-routine contract expiration identified by the CFTC's Market Surveillance staff during the same period.

¹¹ The Exchange issued a notice approximately 18 months prior to the specification changes, providing information and instructions regarding upgrades. The notice affirmed that the upgrade should be contracted at a mutually agreed-upon price.

MSD, in cooperation with CFTC Market Surveillance staff, remained in constant contact with the facility during and after expiration, requesting the facility to provide a written rationale for charging 20 cents and how it handled the upgrading process.¹² Part of MSD's inquiry was to determine if the facility was using its market power to gain an unfair advantage. The ESF contained memoranda documenting conversations between MSD and the facility, explanatory letters written by the facility, logs of subsequent MSD actions in response to the facility's actions and explanations, open interest comparisons, market news, and extensive spread and cash price data. The documentation provided the necessary support for MSD to refer the matter to the BCC. Charges were issued against the facility and it was subsequently fined \$25,000 for providing deficient information to the market regarding its upgrade fees.

C. *Large Trader Reporting System*

MSD monitors activity in all markets through its large trader reporting system, called the Market Surveillance Large Trader ("MSLT") program. MSLT allows the Exchange to collect and maintain a substantial database of large trader information.

Under Exchange rules, CBOT clearing members must transmit to the Exchange daily position data when reportable position levels meet Exchange-established thresholds for each contract.¹³ When an account reaches a reportable level, the clearing member generally uses File Transfer Protocol to electronically submit a daily large trader file to CME Clearing, but also may use the on-line CBOT Large Trader Reportable Positions ("LTRP") application. The LTRP application allows users to submit, view, change and update reportable positions electronically.¹⁴

¹² MSD, as well as market participants, considered 20 cents per bushel for the upgrade to be unreasonable and out of line with market expectations.

¹³ A list of all CBOT reportable levels can be found in Appendix 2.

¹⁴ Non-member futures commission merchants ("FCMs") and foreign brokers are required to provide daily large trader reports, including reportable futures and options positions, to the Exchange by e-mail or fax.

MSD requests a CFTC Form 102, which contains account ownership and control information, for each new large trader. The account information is then entered into the Large Trader Aggregation application, the Exchange's aggregation program database (commonly referred to as the "Aggy Program"). Large trader aggregation is used to identify accounts that should be aggregated based on common ownership or control, for the purposes of speculative position limits. The primary functions of the Aggy Program are to enter new accounts, delete and modify existing accounts, search accounts, and aggregate accounts. The Aggy Program's functionality allows analysts to sort data by various fields, execute queries, filter results, and print views of the data.

The Aggy Program extracts Form 102 account information and applies it to the large trader file to identify the position owners. During this merging process, an Exchange index number ("EIN") is generated, if one does not already exist for the account, and is attached to each reportable trader account. The integrated information, *i.e.*, the Form 102 account information and the large trader file, is loaded into MSLT.

Reportable positions are processed into MSLT daily on a delta-adjusted basis.¹⁵ MSLT is used extensively by analysts in performing their daily surveillance routines and to enforce compliance with CBOT rules regarding reportable accounts, speculative position limits, omnibus account reporting, open interest reporting, and account aggregation. MSLT, which was significantly enhanced in July 2005, maintains 18 months of large trader data on-line, after which time the data are archived for five years.

¹⁵ "Delta" is generally used to refer to the equivalent position in futures contracts that is needed to have a risk profile identical to an options position. It is a measure of the rate of change in an option's theoretical value for a one-unit change in the price of the underlying futures contract. A futures equivalent is calculated by multiplying the number of options by the previous day's risk factor (delta) for the same option series. Since the Division's 2001 Review, MSLT has been enhanced to automatically provide delta-adjusted options positions, replacing the need to manually apply the appropriate delta factor to compute options positions. MSLT includes a feature that enables analysts to click a button to view positions calculated with not only current day delta factors, but also previous day delta factors.

Analysts access MSLT data through a series of computer reports and on-line screen applications, which analyze large trader activity according to predetermined sorts. These reports facilitate the monitoring of large trader positions for concentrations of ownership and potential collusive or concerted trading activity. For example, the Large Trader Report ranks traders' position by size. A new feature calculates position concentration as a percentage of open interest, to allow analysts to determine at any given point in time the total market exposure of market participants in a particular account and to detect potential disruptions to the market. Another MSLT application allows analysts to examine trading activity over a period of time for a particular account or large trader. In addition, MSLT's new search capabilities make it more interactive from a sorting perspective. For example, analysts may now choose an account with or without option positions, ranked by net futures equivalents, or by overall combined positions.¹⁶ Furthermore, data may be exported to other applications, such as an Excel spreadsheet or an Access database, to manipulate and query the data and to conduct analyses of traders' positions on a broad or a narrow scope with greater ease and efficiency.

Other reports and on-line applications show open interest and open interest adjustments. These reports allow analysts to review preliminary open interest early in the morning prior to final processing. Analysts are then able to identify potential problems or inaccuracies and to make market calls, as appropriate, earlier in the day than was previously possible.¹⁷

Surveillance efforts are also augmented by the MSD Large Trader Exception Position Discrepancy ("MLTE") report. The MLTE report identifies discrepancies between open interest and large trader positions. Sorted by firm, commodity, and contract month, the report compares long and short open interest to long and short position data and indicates any differences between

¹⁶ A copy of the Large Trader Reports can be found in Appendix 3.

¹⁷ A copy of the Open Interest Reports can be found in Appendix 4.

them. The report enables analysts to monitor when a clearing member incorrectly reports its position(s) and to then request the necessary adjustments. Position adjustments may result in changes in open interest and have cumulative market impact.¹⁸

D. Enforcement of Speculative Position Limits, Hedge Exemptions, and Position Accountability

1. Speculative Position Limits

The following CBOT markets are subject to position limits:¹⁹ Corn (and mini-Corn); Soybeans (and mini-Soybeans); South American Soybeans; Wheat (and mini-Wheat); Oats; Rough Rice; Soybean Oil; Soybean Meal; Soybean Crush Options; 10-Year Interest Rate Swap; 5-Year Interest Rate Swap; U.S. Treasury Bonds; 5-Year U.S. Treasury Notes; 2-Year U.S. Treasury Notes; 30 Day Federal Funds; mini-Eurodollars; Dow Jones Industrial Average (“DJIA”) - \$25 multiplier; mini-DJIA - \$5 multiplier; 5,000 oz. Silver (and mini-Silver); 100 oz. Gold (and mini-Gold); and Ethanol.

Analysts use MSLT’s Over the Limit (“OTL”) report to detect potential speculative position limit violations as well as for general market surveillance purposes. The OTL report incorporates large trader data, and speculative position limit and hedge exemption information, to identify accounts that may be holding positions in excess of speculative position limits. The report is sorted by commodity and EIN. The EIN is utilized to aggregate positions by owner and/or controller, as reported by one or more clearing firms. For each EIN listed, the OTL report displays the positions for each contract month in a given commodity; the account name and number; and the clearing firm(s) carrying the positions. The report also displays the authorized hedge exemption limits, if applicable, the account type, and an OTL message that indicates if the

¹⁸ A copy of the MLTE Report can be found in Appendix 5.

¹⁹ The position limits are applicable on a futures-equivalent basis.

account(s) with the listed EIN is over the spot month, single month, or all months combined limit. The OTL message also indicates if the account is over its approved hedge limits.²⁰

The accounts identified in the OTL report typically fall into one of four categories: bona fide hedging positions, omnibus positions, reporting errors, or speculative positions exceeding the limits. For each cited EIN, an analyst will determine whether conditions exist that warrant further review and contacting the firm(s). Thresholds for speculative position limit levels and/or hedge exemption levels can be set or adjusted on-line through the CME Portal for any commodity or for any account.

The Division finds that MSD's use of the OTL report, together with analysts' routine contact with major market participants to gather information regarding trading positions, strategies, and cash market positions, is an effective program for monitoring speculative positions and for detecting violations of speculative limits.

a) Speculative Position Limit Investigations

MSD closed 46 investigations during the target period that involved the review of potential speculative position limit violations. Division staff reviewed a random sample of 14 investigations. Of those 14 investigations, two involved a second violation within a 12-month period, resulting in fines of \$5,000 and \$10,000; five involved data entry errors of which one was closed administratively and four received verbal reminders; four involved recordkeeping errors and reminder letters were issued for each; one involved a speculative limit violation that resulted in a hedge application being filed and an exemption being granted; and two dealt with aggregation issues in which the positions needed to be disaggregated by MSD and were closed administratively.

²⁰ A copy of the OTL Report can be found in Appendix 6.

The Division found that the documentation in each investigation file was complete and included a thorough investigative summary memorandum, reference to appropriate CBOT rules, copies of correspondence (including any letters issued by the CFTC), an activity log, and disciplinary outcome, if any (*i.e.*, reminders or warning letters, or fines). All of the investigations reviewed were completed in a timely fashion.

2. Hedge and Other Exemptions

Exchange rules permit the Exchange to grant exemptions from speculative limits for *bona fide* hedges, risk management positions, cash/futures arbitrage, intra-market spreads and inter-market spreads.²¹

Under the Exchange's rules, every member or member firm which owns, controls, or carries positions on behalf of an entity who seeks classification of a position as a *bona fide* hedge or economically appropriate hedge must file a statement with the Exchange.²² The statement must include a description of the intended positions, potential size, and a statement affirming that the kinds of intended positions are *bona fide* or economically appropriate hedging positions. Whenever there is a material change in the information provided in the entity's most recent statement, a supplemental statement must be submitted to update and confirm previous information filed with the Exchange by every member or member firm owning, controlling or carrying such entity's positions.²³ MSD may request additional relevant information necessary to ensure compliance with the Exchange's speculative limit rules, and may, in its discretion,

²¹ See CBOT Rules 425.02 and 425.03.

²² Corn, Oats, Soybean, Soybean Oil, Soybean Meal and Wheat futures contracts are subject to CFTC Regulation 1.3(z), which defines *bona fide* hedging transactions and positions.

²³ CBOT Rule 425.03 requires that the initial statement of the member or a member firm prepared on behalf of an entity be filed no later than 10 business days after the day on which the entity's position exceeds the speculative limit for each contract specified in CBOT Rule 425.01(b). Any necessary supplemental statement must be filed no later than 10 business days after the day on which the entity's position exceeds the level specified in the most recent statement.

amend, revoke or otherwise limit the classification of positions as *bona fide* hedges or economically appropriate hedges.

In addition to Exchange rules, MSD has established comprehensive guidelines for the hedge exemption process. All participants must complete an Application for Hedgers to Exceed Speculative Limits in Futures.²⁴ The application must indicate the quantity of contracts the account is applying for in excess of current speculative position limits, which side of the market (long or short) the exemption is for, and the nature of the business engaged in by the applicant. All applications must include details of cash market positions hedged for financial or equity products.²⁵ In the case of agricultural products, which encompass the vast majority of all exemption applications, a CFTC Form 204, and/or documentation of annual anticipated processing, feeding, or milling requirements must accompany the application.²⁶

Position limit exemption applications are either submitted in anticipation of exceeding a position limit or as a result of exceeding a position limit. Accounts that exceed a position limit in any commodity are required to submit a hedge exemption application within ten business days. In addition, accounts that exceed a spot month position limit are required to submit cash market/hedging documentation within the time frame specified by MSD. The analyst who monitors the commodity contacts the entity to determine the specific price risk that was being hedged, requests updated cash position information and re-examines the account's hedging needs.

²⁴ A copy of CBOT's hedge application can be found in Appendix 7.

²⁵ Due to the large speculative position limits for equity index contracts, hedge exemption requests for such contracts are rare.

²⁶ CFTC Form 204 contains information about reportable entity's cash positions in grains and soybean products. The form is required from reportable traders whose positions exceed federally imposed position limits.

a) Hedge Exemption Investigations

One hundred and twelve position limit exemptions were on file with MSD during the target period. Of the 112 exemptions, 110 were for agricultural contracts, one was for the mini Silver contract, and one was for the Gold contract. 110 of the exemptions were hedge exemptions granted by the Exchange and two of the exemptions (both for agricultural products) were in the form of no-action relief granted by the Commission.

Division staff reviewed the hedge exemption files for 18 market participants (some market participant files included multiple exemption requests). Each file included a complete application and cash market documentation, or a CFTC approval letter. The files also included MSD reviews of the applicant's calculations of the appropriate hedge positions. All exemptions were approved based only on such verified hedge amounts. In one example reviewed by the Division, an exemption was not granted as originally requested. An exemption was requested in Wheat as a cross hedge for Barley. The exemption was partially denied due to the fact that MSD found a lack of appropriate price correlation between the two grains. In this instance, MSD granted a reduced hedge amount that was supported by the submitted documentation.

3. Position Accountability

MSD analysts routinely monitor large positions above the thresholds of CBOT's position accountability rules. The Exchange's position accountability rules are applicable to the following contracts: US Treasury Bonds; 10-, 5-, and 2-Year Treasury Notes; 30-Day Fed Funds; Binary Options on the Fed Funds; and 30-, 10-, and 5-Year Interest Rate Swaps. An entity that holds or controls, or a member firm that carries for another entity, aggregate positions in excess of those specified in CBOT's position accountability rules, are required to provide information regarding the nature of the position, trading strategy, and hedging information, if applicable. In addition, the entity shall be deemed to have consented, when so ordered by the Exchange acting

in its discretion, not to further increase its positions that exceed specified levels. Such positions must be initiated and liquidated in an orderly manner.

Since, as part of its routine surveillance, MSD regularly contacts major participants in CBOT markets to gather information regarding the nature of positions, trading strategies, and hedging information, it is not generally necessary for MSD to formally invoke position accountability rules. As explained above, communications between MSD and market participants, which occur on a regular basis, are collected in EFSs.²⁷ Although MSD will invoke the Exchange's position accountability rules if necessary, it has found that the routine collection of information from market participants regarding trading positions, strategies, and cash market positions is an adequate program to monitor position accountability.

E. Monitoring of Exchanges of Futures for Related Positions: Exchanges of Futures for Physicals, Exchanges of Futures for Swaps, and Exchanges of Futures for Risk

1. General Requirements

CBOT Rule 331.08 generally governs Exchanges of Futures for Related Positions ("EFRPs"), which include EFPs, EFSs, and EFRs.²⁸ EFPs are permitted in all CBOT futures contracts. EFSs are permitted in U.S. Treasury Bond futures; Long Term, Medium Term and Short Term U.S. Treasury Note futures; CBOT Dow Jones-AIG Excess Return Commodity Index futures; and 30-Year, 10-Year and 5-Year Interest Rate Swap futures. EFRs are permitted in all of the same contracts as EFSs, in addition to agricultural futures contracts. Options on futures are not a permissible component of an EFRP.²⁹

²⁷ See Sections III.A. and B.

²⁸ An EFR is an exchange of futures for, or in connection with, over-the-counter ("OTC") derivative transactions. CBOT requires that the OTC component of an EFR comply with applicable CFTC regulatory requirements.

²⁹ The total EFRP volume during the target period was 21.6 million contracts. The breakdown of this volume is as follows: EFPs- 20,086,167 contracts (130,980 transactions); EFRs- 221,465 contracts (17,654 transactions); and EFSs- 1,316,206 contracts (763 transactions).

An EFRP's "related position" (*i.e.*, a cash, swap, 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 to the underlying commodity. EFRPs consist of two discrete, but related simultaneous transactions. One party must be the buyer of (or have the long market exposure associated with) the related position and the seller of the corresponding futures, and the other party must be the seller of (or have the short market exposure associated with) the related position and the buyer of the corresponding futures.

The Exchange requires that the accounts involved on each side of an EFRP have different beneficial ownership, be under separate control, or involve separate legal entities. The quantity covered by the related position must be approximately equivalent to the quantity covered by the futures contracts. An EFRP execution time must be recorded on the futures order ticket and on the record submitted to CME Clearing.³⁰ In addition, both parties to a transaction must maintain all documents relevant to the futures and the cash, swap, or OTC transactions, and must provide such documents to the Exchange upon request.

2. EFRP Reviews

As part of its routine surveillance of market activity, MSD reviews EFRPs for execution in a bona fide manner and compliance with CBOT rules. Since the Division's 2001 Review, MSD has developed a new computer application, the Market Review of Ex-Pit Data ("MRED"), to help detect potential violations of CBOT rules as they pertain to ex-pit (outside of the pit) transactions.³¹ Previously, MSD staff could conduct only general queries of ex-pit transactions and the reviews tended to represent random audits; the old application would load the trades and

³⁰ EFRPs must be reported to CME Clearing by both parties to the transaction. EFRPs executed between 7:00 am and 6:00 pm must be reported within one hour of execution. EFRPs between 6:00 pm and 7:00 am must be reported no later than 8:00 am.

³¹ Ex-pit transactions include EFRPs, transfer trades, wholesale transactions, and block trades.

allow analysts to review transactions, but without analytical functionality. MRED provides for complex search capabilities, pattern match detection, identification of anomalies, maintenance of profiles, and generation of statistical data. This allows MSD to employ a research-based approach to identify ex-pit transactions most likely to represent violations of Exchange rules, including more efficient identification of potentially contingent EFRPs, unusually large transactions relative to established profiles, an account executing an EFRP for the first time, and the frequency of accounts transacting EFRPs with one another. These enhanced capabilities allow MSD to perform broader and more effective reviews and statistical analyses of EFRPs.

MSD uses MRED daily to select particular EFRPs for further review. An EFRP review consists of four phases: request, pre-analysis, analysis, and review. An analyst requests trade confirmation statements from the clearing firms executing each side of the trade. These include futures account statements and order tickets demonstrating the futures exchanged and the parties involved. The analyst also requests documentation supporting the related side of the transaction. The analyst reviews the documents submitted, summarizes the analysis, and follows-up with correspondence or a conference call requesting that the firm address and respond to any potential violations and provide supporting documentation. Upon completion of an EFRP review, a report is prepared summarizing the details of the transaction(s) and the analyst's findings. If MSD decides to forward the matter to the BCC for disciplinary action an investigation will be opened and a formal investigative report will be prepared.

3. EFRP Investigations

MSD completed 55 EFRP investigations during the target period.³² Four of these matters were referred to the BCC, resulting in one reminder letter and the imposition of four fines.³³ The Division reviewed 10 of the 55 investigations and found that the investigations were thorough, expanded when appropriate, and completed in a timely manner. Each file contained an investigative memorandum, recommending either closing the investigation administratively, issuing a reminder or warning letter, or referring the matter to the BCC. The files contained all correspondence and submitted documentation, appropriate analysis, and activity logs documenting the course of the investigation, as well as charts describing the flow of the futures and the related product. MSD routinely analyzed the futures price relative to the day's trading range, as well as the price differential (basis price) at which the related product and futures contracts were exchanged, to determine if the differential reflected market prices.³⁴

F. Miscellaneous MSD Investigations

MSD closed seven investigations related to the delivery process during the target period, all of which were reviewed by Division staff. One of the investigations was closed with no administrative action, three resulted in warning letters, and three resulted in fines of \$2,500, \$5,000, and \$62,500, respectively. In the matter that resulted in the imposition of the \$62,500 fine, a clearing firm missed both the 10:00 am deadline for having the securities at its bank and

³² The 55 EFRP investigations included 50 EFP investigations, two EFR investigations, and three EFS investigations.

³³ The amounts of these fines were \$130,000; \$10,000; \$5,000; and \$2,500.

³⁴ The investigations examined by the Division were illustrative of the different types of EFRP violations flagged through MRED. These violations included, among other things, execution of an EFRP to offset errant EFRPs, execution of contingent EFRPs, and a multiparty (more than two) EFP.

the 1:00 pm deadline for making delivery of the 2-year Treasury Note futures contract. The deliveries were completed the following business day.

MSD also closed four investigations related to Exchange reporting and recordkeeping requirements, all of which were reviewed by Division staff. One of the investigations resulted in a verbal MSD warning, two of the investigations were combined and a firm was fined \$25,000 for significantly misreporting open interest in Corn and 10-year Treasury Note futures, and one firm was fined \$10,000 for using a transfer trade to offset positions in a delivery month.

The Division found that all 11 of the investigations related to deliveries and the Exchange's reporting and recordkeeping requirements were well-documented, thorough, and completed in a timely fashion.

IV. CONCLUSION

The Division finds that the Exchange maintains an effective and comprehensive market surveillance program. MSD's daily market surveillance activities include monitoring futures and cash market prices, volume, open interest, deliverable supply or the cash settlement process, and market news. MSD also monitors contracts daily for violation of Exchange speculative position limit rules. The Exchange maintains a sophisticated large trader reporting system that contains a substantial database of position information. Relevant large trader data and exception reports are readily available and easily accessed by analysts. Analysts are also in regular contact with market participants regarding trading strategies and trading and cash market positions.

MSD maintains extensive Expiration Summary Files that are well documented and thoroughly summarize analysts' surveillance of expiring contracts. Surveillance of expiring contracts is heightened well in advance of the last trading day, focusing on position concentrations, large trader positions, deliverable supplies, and the relationship between open interest and deliverable supplies. The July 2006 Wheat contract was the only non-routine

expiration during the target period. MSD maintained close observation of the market and was in daily contact with the warehouse that caused the problem. The contract expired in an orderly manner.

MSD reviews EFRP transactions daily. Since the Division's 2001 Review, the Exchange has implemented an automated application that supports MSD's efforts to identify EFRP transactions that may have been executed in violation of Exchange rules. This application has resulted in more efficient identification and review of potential EFRP violations. During the target period, MSD completed 55 EFRP investigations, four of which were referred to the BCC.

In addition, MSD completed seven investigations relating to delivery and four investigations relating to CBOT's recordkeeping and reporting requirements. The Division's review of investigation files revealed that the investigations were thorough, well-documented, and completed in a timely fashion.

Based on the foregoing, the Division has no recommendations.