

For Public Release

**MARKET SURVEILLANCE  
RULE ENFORCEMENT REVIEW  
OF THE  
NEW YORK MERCANTILE EXCHANGE**



**Division of Market Oversight  
May 19, 2008**

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# MARKET SURVEILLANCE RULE ENFORCEMENT REVIEW OF THE NEW YORK MERCANTILE EXCHANGE

## I. INTRODUCTION

The Division of Market Oversight (“Division”) has completed a rule enforcement review of the market surveillance program of the New York Mercantile Exchange (“Exchange”) for compliance with applicable provisions of Section 5(d) of the Commodity Exchange Act (“Act”), as amended by the Commodity Futures Modernization Act of 2000 (“CFMA”), and Part 38 of the Commission’s regulations.<sup>1</sup> The review covers the target period of January 1, 2006 to January 1, 2007 (“target period”).<sup>2</sup>

This review focuses on two core principles that relate to an Exchange’s market surveillance program: Core Principle 4, *Monitoring of Trading*, which 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*, which relates to an exchange’s program for enforcing its speculative position limits and position accountability

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<sup>1</sup> The Exchange is comprised of two divisions, the NYMEX division and the COMEX division, which were formed by the merger of the New York Mercantile Exchange and the Commodity Exchange, Inc. in 1994. After the merger, the trading operations of each exchange were continued as the two divisions, offering trading in their respective futures and options contracts: energy, platinum, and palladium for the NYMEX division, and gold, silver, and copper (plus aluminum, added since the merger) on the COMEX division. The focus of this review is limited to the operation of the Exchange’s market surveillance program with respect to trading on the NYMEX division. Therefore, while the terms “Exchange” or “NYMEX” can refer to the Exchange as a whole where this is obvious from the context, they generally refer to the NYMEX division and exclude the COMEX division.

<sup>2</sup> Rule enforcement reviews prepared by the Division are intended to present an analysis of an exchange’s overall compliance capabilities for the period under review. Such reviews deal only with programs directly addressed in the review and do not assess all programs. The Division’s analyses, conclusions, and recommendations are based, in large part, upon the Division’s evaluation of a sample of investigation and disciplinary case files, and other exchange documents. This evaluation process, in some instances, identifies specific deficiencies in particular exchange investigations or methods but is not designed to uncover all instances in which an exchange does not address effectively all exchange rule violations or other deficiencies. Neither is such a review intended to go beyond the quality of the exchange’s self-regulatory systems to include direct surveillance of the market, although some direct testing is performed as a measure of quality control.

rules. Appendix B to Part 38 provides acceptable practices for demonstrating compliance with Core Principles 4 and 5.

For purposes of this review, Division staff interviewed officials and staff from the Exchange's Market Surveillance Department ("MSD"). The Division 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, position accountability enforcement, and speculative position 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 target period meetings of Exchange committees responsible for market surveillance matters.

The Division provided the Exchange an opportunity to review and comment on a draft of this report on May 2, 2008. On May 7, 2008, Division staff conducted an exit conference with Exchange officials to discuss the report's findings and recommendations.

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

### **A. Findings**

#### **Market Surveillance Staff**

- NYMEX's 14-person market surveillance staff, which has adequate training and experience, conducts daily monitoring of futures and cash market prices, market news, volume, open interest, and data on available supply and demand relating to each Exchange contract. MSD's Large Trader System staff team monitors the trading of all reportable traders. MSD also conducts regular review of EFRP transactions and of off-Exchange bilateral transactions cleared on ClearPort Clearing, and monitors compliance with the Exchange's position limit and hedge exemption rules.
- With appropriate staff increases, NYMEX should have sufficient staff to maintain an adequate market surveillance program. Although MSD has experienced a modest staff increase of two positions since the last NYMEX Market Surveillance Rule Enforcement Review in 2003, its size has not kept pace with the approximate tripling of volume, quadrupling of product offerings, and 400-fold increase in the volume of over-the-counter transactions cleared on ClearPort Clearing which the Exchange has experienced over the same period.

#### **Large Trader Reporting System**

- MSD's principal tool for monitoring trading is NYMEX's Large Trader Reporting System. The system enables MSD to aggregate and review a trader's positions at multiple clearing members, and to aggregate and review the combined positions of all related affiliates. Since the last review, NYMEX has added a number of new or upgraded electronic surveillance tools to LTRS that are designed to enhance MSD's monitoring of the Exchange's markets. MSD estimates that during the target period, daily review of LTRS reports generated more than 90 percent of the market surveillance inquiries opened by MSD.

#### **Routine Surveillance Of Market Fundamentals**

- MSD conducts daily review of the trading and positions of large traders, monitors market factors that could affect orderly liquidation, and analyzes atypical price, spread, and basis relationships and other unusual market circumstances that could raise the potential for a liquidation problem. MSD also maintains frequent contact with market participants.

#### **Surveillance Of Expiring Contracts**

- MSD heightens surveillance of expiring contracts to detect and prevent price manipulations and facilitate orderly liquidations, focusing on position concentrations, large trader positions, and the relationship between deliverable supply and open interest. Expiration control files maintained for each contract expiration are well documented.

- Several unleaded gasoline contract expirations during the target period required particular scrutiny by MSD, due to special circumstances created by the nationwide, legally-mandated phase-out of a previously-used gasoline additive discontinued because of environmental protection concerns. MSD took a number of steps to ensure the orderly functioning of the Exchange's gasoline markets and facilitate the transfer of open interest during the phase-out period. In the end, the expirations of the final months of the New York Harbor Gasoline contract unfolded without significant problems.
- A number of natural gas futures contract expirations required expanded scrutiny by MSD during the target period, due to significant price volatility and high trading volume in the entire U.S. market for natural gas. MSD increased contacts with market participants concerning position accountability and position limits, and initiated reviews and investigations of trading. MSD also undertook an appropriate "lessons learned" review, and took a number of significant steps to further improve its process for handling similar situations. As a result, recommendations that the Division might have made with respect to these matters have already been undertaken by the Exchange.

#### **Position Accountability Levels, Position Limits, And Hedge Or Swap Exemptions**

- NYMEX has position accountability levels for all contracts, and has position limits for all contracts involving physical delivery. MSD maintains a hedge exemption register listing all exemptions granted for each commodity, together with an exemption file for each exemption applicant. During the target period, MSD took action on 786 exemption applications. Generally, files were well documented and contained appropriate one-page summaries of the basis for the request and the action taken.
- In some instances, however, the exemption applicant did not appear to have demonstrated sufficient cash market or swap exposure to justify the requested exemption. Some files did not appear to document hedge exposure at all, while others showed exposure well below the level of the exemption granted. In addition, most applications for temporary, expiration-month-only exemptions did not include an application form completed by the market participant to substantiate the request.
- MSD conducts daily review of LTRS reports that identify all market participants whose positions are approaching or have reached applicable accountability levels. MSD has appropriate procedures for assessing such positions and taking any needed action. MSD opened 236 position accountability inquiries during the target period. MSD responded promptly when accountability levels were reached, and made appropriate and timely decisions regarding responsive action.
- MSD also conducts daily review of LTRS reports that identify all positions that have reached or exceeded position or exemption limits, and can apply summary sanctions for violations. MSD opened 405 inquiries into possible position or exemption limit violations during the target period. Violations were found in 34 inquiries resulting in issuance of warning letters or other summary sanctions, and in two inquiries which

evolved into investigations and subsequent disciplinary proceedings. MSD addresses potential violations in a timely fashion, maintains well documented files, and generally follows the sanctioning process provided in Exchange rules.

- Exchange rules specifically authorize disciplinary action beyond summary sanctions against any market participant, whether member or non-member, when a market participant exceeds position or exemption limits during the spot month, holds a position greater than 150 percent of applicable limits, or commits a severe abuse of Exchange rules. Penalties can include limiting, conditioning, or denying access to the market. However, when limit violations by two non-member market participants rose to this level, the Exchange did not bring disciplinary charges, but only issued warning letters.

### **Monitoring Of Exchange Of Futures For Related Positions Transactions**

- MSD conducts daily review of Exchange of Futures for Related Positions (“EFRP”) transactions, including Exchange of Futures for Physicals (“EFP”) and Exchange of Futures for Swaps (“EFS”) transactions in all Exchange futures contracts, and Exchange of Options for Options (“EOO”) transactions in the Exchange’s energy options contracts, to ensure their compliance with NYMEX rules and verify the bona fide nature of the underlying transactions. This review includes EFSs and EFPs posted on the Exchange’s ClearPort Clearing System. Analysts performing EFRP review are aided by new LTRS electronic surveillance tools.
- MSD opened 163 inquiries into the bona fides of EFRPs and 209 inquiries to verify the eligible contract participant status of EFRP participants. MSD also conducted two EFRP investigations, one of which revealed non-bona-fide EFPs. MSD’s inquiries and investigations were well documented, thorough, expanded when necessary, and adequate for purposes of verifying the bona fides of the EFRPs examined.

### **Miscellaneous MSD Inquiries And Investigations**

- MSD initiated and closed 17 inquiries related to position reporting by clearing members, 23 inquiries into a variety of other potential violations, and 11 inquiries resulting from referrals and questions received from Commission staff. These miscellaneous inquiries resulted in issuance of nine warning letters to eight member firms and one floor member. Inquiry files were well documented, and MSD addressed all Commission referrals and questions expeditiously.
- MSD closed six investigations during the target period, involving possible cross trading, possible wash trading, natural gas trading near the close, crude oil trading in outer delivery months, and erroneous position reporting. Two investigations resulted in disciplinary action, one concluded by issuance of a warning letter, and the other by assessment of a total of \$80,000 in fines and a cease and desist order. The Exchange also completed disciplinary action begun prior to the target period on the basis of an MSD investigation into prearranged trading, noncompetitive trading, and withholding of orders

from the market. The sanctions imposed included fines totaling \$307,000, and orders to cease and desist from further similar violations.

## **B. Recommendations**

- The Exchange should increase its MSD staff to a level that will keep pace with the Exchange's growth in volume and products offered and ensure the continued adequacy and efficacy of the Exchange's market surveillance program.
- MSD should review its procedures for granting or denying position limit exemption requests, and make adjustments as needed to ensure that all exemptions granted are based on the applicant's demonstrated cash market or swap exposure. To help ensure that this goal is met, MSD should include in all exemption files a work sheet showing how staff determined the appropriate exemption level to be granted, and should require all exemption applicants to complete an exemption application form.
- The Exchange should review its program for monitoring and sanctioning position and exemption limit violations, and make whatever adjustments are needed to ensure that position and exemption limit offenses by any market participant that involve serious and substantial violations of Exchange rules result in disciplinary proceedings and sanctions sufficient to deter similar conduct by market participants.



### III. CHANGES AT NYMEX SINCE THE LAST REVIEW

Since the Division's last NYMEX Market Surveillance Rule Enforcement Review in 2003 (the "2003 Review"), NYMEX has experienced a number of significant changes with respect to both the Exchange itself and the nature of the overall commodity futures marketplace. These changes have had a material impact on the Exchange and its business. The most noteworthy of the changes include the following:

- **Volume growth.** NYMEX's total trading volume from September 1, 2001 to September 1, 2002, the target period for the 2003 Review, was 122,494,604 contracts traded, an average of approximately 10,200,000 contracts per month. For 2006, the target period for this review, NYMEX's total volume was 191,947,915 contracts traded, an average of approximately 16,000,000 contracts per month. During 2007, NYMEX's total volume was 353,608,586 contracts traded, an average monthly volume of more than 29,000,000 contracts traded, nearly three times the Exchange's average monthly volume at the time of the 2003 Review.
- **Product line expansion.** The Exchange offered a total of 102 products for trading as of the end of 2003. By the end of 2006, the Exchange's product line had expanded to 308 products, and it had reached a total of 383 products, nearly four times the number offered in 2003, as of the end of 2007.
- **Shift to predominantly electronic trading.** During the target period for the 2003 Review, approximately 97 percent of the Exchange's average monthly volume was traded by open outcry on the Exchange's trading floor, while only 3 percent was traded on NYMEX's ACCESS electronic trading system. In September 2006, the Exchange commenced electronic trading of NYMEX products on the Globex system of the Chicago Mercantile Exchange ("CME"), pursuant to an agreement between NYMEX and CME. By December 2006, NYMEX trading on Globex accounted for approximately 54 percent of the Exchange's monthly volume. Electronic trading constituted approximately 79 percent of the Exchange's total volume in March 2008.<sup>3</sup>

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<sup>3</sup> The electronic volume percentages for December 2006 and March 2008 that are compared with the volume percentages at the time of the 2003 Review exclude NYMEX's volume in bilateral, over-the-counter transactions cleared through the Exchange's ClearPort Clearing facility, because ClearPort Clearing did not exist during most of the target period for the 2003 Review, and inclusion of ClearPort Clearing volume in calculation of the later volume percentages would result in an unparallel comparison. The Exchange has also experienced significant growth in ClearPort Clearing volume, which expanded from a monthly volume of 24,388 contracts cleared in August 2002 (at the end of the target period for the 2003 Review) to 9,637,077 contracts cleared in March 2008, a nearly 400-fold increase. ClearPort Clearing is discussed below at pages \_\_\_-\_\_\_.

- **Demutualization.** At the time of the 2003 Review, NYMEX was owned by its members. On November 16, 2006, NYMEX was demutualized, and today it is a publicly held corporation whose shares are traded on the New York Stock Exchange.
  
- **Competing products linked to NYMEX energy contracts.** Since the 2003 Review, and in fact during the target period for the present review, a NYMEX competitor has launched electronic trading in products linked to, and cash settled on the basis of, NYMEX’s two flagship energy futures contracts, West Texas Intermediate Light Sweet Crude Oil (“CL”) and Natural Gas (“NG”).<sup>4</sup> Both linked products continue to sustain significant trading volume, albeit at levels lagging the trading volume of NYMEX’s CL and NG contracts. Such sustained volume in competing but linked products at different exchanges is unprecedented, and in this case the commodities involved have significant impact on the economy of the United States and the world. The existence of these linked products has created a changed market environment for NYMEX in two important respects. One is greater market opacity: NYMEX can no longer see or conduct routine market surveillance with respect to the entire crude oil or natural gas futures position held by each market participant, as it could before these linked products existed.<sup>5</sup> The other is increased incentive for market manipulation: if a market participant could move the settlement price of one of the NYMEX products involved, the participant could profit on a corresponding position in a competing product that is cash settled on the basis of the NYMEX settlement price, without obviously appearing to do so.

All of these developments have significance for surveillance of the Exchange’s markets.

Accordingly, for this Review the Division has assessed the adequacy of the Exchange’s market surveillance program in light of the new market environment created by these changes.

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<sup>4</sup> ICE Futures Europe, which is a United Kingdom exchange located in London and regulated by the U.K. Financial Services Authority (“FSA”), and is a subsidiary of IntercontinentalExchange (“ICE”), lists a WTI crude oil futures contract that is cash settled on the basis of the NYMEX CL settlement price. The Intercontinental Exchange, which is an exempt commercial market (“ECM”) based in Atlanta, Georgia (“ICE Atlanta”), and an affiliate of ICE, lists an over-the-counter (“OTC”) natural gas product that is cash settled on the basis of the NYMEX NG futures contract.

<sup>5</sup> The Commission has taken steps to ensure its own access to position data for these linked contracts. In the case of ICE Futures Europe WTI crude oil futures, the Commission receives end-of-week data each week for the expiring and nearby contracts, and receives daily data each day during the last week of the expiration month, pursuant to a memorandum of understanding with FSA. In the case of The Intercontinental Exchange’s natural gas contract, the Commission receives daily position data for all contract months, pursuant to a series of special calls to The Intercontinental Exchange. Both of these data sets are integrated with the Commission’s normal large trader position data. This enables Commission staff to evaluate the combined crude oil futures positions of traders on NYMEX and ICE Futures Europe, and the combined natural gas futures positions of traders on NYMEX and The Intercontinental Exchange. It should also be noted that legislation recently passed by both the Senate and the House of Representatives and currently in conference would impose large trader reporting requirements on certain ECM contracts—including The Intercontinental Exchange’s natural gas contract—that are cash settled on the basis of the settlement prices of designated contract market (“DCM”) contracts such as the NYMEX NG contract.

In part as a response to these developments, NYMEX has undertaken a number of modifications of its market surveillance program, including a restructuring of its market surveillance staff, and the development of several new, sophisticated electronic surveillance tools for staff to use in monitoring NYMEX markets. These modifications are discussed in detail in the course of this report.

## **IV. 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. This data should be evaluated on a daily basis to enable the exchange to respond appropriately to potential market disruptions or abusive practices. An effective surveillance program for an exchange with multiple products and substantial numbers of traders should include an automated large trader reporting system.

To facilitate orderly liquidation of expiring contracts and diminish expiration problems arising from excessively large positions, an exchange may need to establish position limits for some commodities, although it may substitute position accountability for position limits where the threat of excessive speculation or manipulation is nonexistent or very low. Spot month limits should be adopted for commodities that have more limited deliverable supplies, or where necessary to minimize a market's susceptibility to manipulation or price distortion. Position limit rules may provide for hedge or other exemptions, and may set limits differently by markets, delivery months, or time periods. An exchange should have an effective program for

enforcement of position limits, and should monitor the continuing appropriateness of approved exemptions. An exchange should also have an effective program for taking regulatory action when a violation of a position or exemption limit is detected, regardless of whether the violation is by a member or non-member.

#### **A. NYMEX Market Surveillance Department**

NYMEX's market surveillance program is conducted by MSD, which is part of the Exchange's Compliance Department. MSD is headed by a Senior Director, who reports to the Vice President, Compliance, and ultimately to NYMEX's Chief Regulatory Officer. A Director-Market Surveillance Counsel reports to the Senior Director and supervises the rest of the MSD staff. A Supervisor leads a team of five analysts who conduct daily surveillance of the Exchange's markets. An Experienced Analyst oversees a three-person Large Trader System staff, including a Supervisor and two Senior Operators, who monitor the trading of all of NYMEX's reportable traders. MSD's Investigation Specialist focuses on whatever market areas currently require close attention, and is also responsible for regular review of Exchange of Futures for Related Positions ("EFRP") transactions and off-Exchange bilateral transactions cleared on ClearPort Clearing.<sup>6</sup> Finally, MSD's Market Surveillance Administrator assists the Senior Director, and monitors speculative position limit exemptions and hedge exemptions.<sup>7</sup>

To enhance real-time sharing of market information, MSD analysts work in an environment similar to a trading room, with all analysts sharing the same work space. This arrangement enables analysts to share useful or important information relating to the Exchange's markets whenever it comes to their attention, rather than waiting for periodic staff meetings. The

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<sup>6</sup> EFRP transactions are discussed below at pages \_\_\_-\_\_\_. Monitoring of off-Exchange transactions cleared on ClearPort Clearing is discussed below at pages \_\_\_-\_\_\_.

<sup>7</sup> An organizational chart for MSD can be found in Attachment A.

resulting information flow is designed to increase MSD's ability to react quickly to real-time market developments.

Each MSD analyst is assigned primary market surveillance responsibility for specific Exchange contracts, and each contract is covered by such an assignment. In addition, a second analyst is assigned backup responsibility for each contract, while all analysts are responsible for additional backup as assigned by the Senior Director. This insures continuous coverage of each contract, and also increases cross-training aimed to afford all analysts a degree of familiarity with the Exchange's various markets.

All MSD staff participate regularly in various types of continuing education relating to futures trading in general and to market fundamentals of the products traded on the Exchange. Examples of programs attended by staff during the target period include the annual, full-day continuing legal education seminar on futures trading presented by the New York Bar Association, Bloomberg Data System presentations on improved use of data feeds, and meetings of the American Petroleum Institute.

As discussed in detail below, MSD staff conduct daily monitoring of futures and cash prices, market news, volume, open interest, deliverable supply, and data on available supply and demand relating to each contract. The procedures analysts follow are detailed in the Exchange's Market Surveillance Procedures Manual. Each analyst's daily routine for surveillance of his or her assigned contracts includes comprehensive review of market data, clearing member and large trader positions, the previous trading day's price performance, industry statistics on cash and futures prices and supply/demand fundamentals, and general market research. MSD staff also review EFRP transactions and block trades. Data concerning electronic trades executed on

Globex is available to MSD analysts in the same manner as open outcry data, and analysts follow the same procedures for reviewing both electronic and open outcry trading.

MSD's current staff of 14 represents the same number of MSD positions maintained by NYMEX during calendar year 2005, and an increase of two positions over the 12 maintained at the time of the Division's 2003 Review. During the target period, the Exchange lost three senior MSD staff with supervisory roles, including a Director, a Senior Manager and an Experienced Analyst. Partly in response to these supervisory staff departures, NYMEX undertook a reorganization of MSD that was completed shortly after the end of the target period. The Exchange promoted leaders for the analyst team and Large Trader Reporting System team from within MSD, and hired a new Director-Market Surveillance Counsel.

As discussed above, since the 2003 Review NYMEX's volume has nearly tripled, and the number of different products traded on the Exchange has nearly quadrupled. The Exchange has also experienced significant growth in the volume of over-the-counter ("OTC") transactions cleared by the Exchange through ClearPort Clearing, which has expanded from a monthly volume of 24,388 contracts cleared in August 2002 (at the end of the target period for the 2003 Review) to 9,637,077 contracts cleared in March 2008, nearly 400 times larger.

The workload of an exchange's market surveillance staff is necessarily affected by both the number and size of positions that require surveillance and review, and the number of different products whose contract terms and market characteristics must be understood if market surveillance is to remain effective. Growth in the number of EFRP transactions used to bring OTC trades to the exchange's clearing house for clearing also increases market surveillance staff workloads. Although MSD has experienced a modest staff increase of two positions since the 2003 Review, its size has not kept pace with the Exchange's dramatic growth in all of these

areas. In addition, the workload of the Exchange's senior Compliance Department staff, including MSD, has recently been increased by the addition of substantial oversight responsibilities in connection with the Dubai Mercantile Exchange ("DME").<sup>8</sup>

In light of the Exchange's current volume and breadth of products offered, and the notable impact of NYMEX trading on world energy prices and the U.S. economy, the Division believes that further staff increases are needed to bring MSD to the minimum size necessary to ensure the continued adequacy and efficacy of NYMEX's market surveillance program. SROs that have demutualized and become for-profit corporations must resolve the potential conflict of interest that can arise between their business objectives and their self-regulatory obligations in favor of continued fulfillment of those obligations. Moreover, while development of sophisticated electronic surveillance tools can increase staff efficiency, in the end, these tools cannot replace the judgment of trained, experienced, and informed compliance staff members. Finally, given the nature and importance of the Exchange's markets, the Division does not believe that the assumption of substantial DME responsibilities by senior members of the NYMEX Compliance Department, and MSD in particular, for an extended period is consistent with maintenance of adequate market surveillance at NYMEX.

The Division therefore recommends that the Exchange increase its MSD staff to a level that will keep pace with the Exchange's growth in volume and products offered, and ensure the continued adequacy and efficacy of the Exchange's market surveillance program. The Division

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<sup>8</sup> DME, a Dubai exchange regulated by the Dubai Financial Services Authority, is a joint venture between Oman Investment Fund (an arm of the government of Dubai), Dubai Holding, and NYMEX. It lists the Oman Crude Oil futures contract in Middle East sour crude oil. The position of Chief Compliance Officer at DME has been vacant for a substantial period of time, and DME compliance department leadership is being provided by NYMEX's CRO and the Senior Director of MSD, who are being required to spend significant amounts of time away from NYMEX on travel to Dubai. Senior NYMEX Compliance staff also have weekly conference calls with DME concerning DME compliance matters. MSD staff currently spend additional staff hours each day conducting surveillance of DME markets, reviewing LTRS reports concerning DME trading, processing Form 102s filed by DME market participants, and contacting clearing members with respect to DME matters. NYMEX Compliance Department staff also conduct trade practice surveillance of DME trading.



also recommends that the Exchange move immediately, without further delay, to hire senior compliance staff in Dubai to oversee compliance activities at DME. The Division finds that NYMEX's present MSD staff has adequate training and experience, and finds that, with appropriate MSD staff increases, NYMEX should have sufficient staff to maintain an adequate market surveillance program. This finding is predicated, however, on full-time attention being paid to NYMEX by the CRO and the senior leadership of MSD. The Division believes that, given the factors noted above, an increased number of market surveillance staff dedicated to oversight of trading in NYMEX products will be needed for adequate market surveillance of those products regardless of the ownership of the Exchange.<sup>9</sup>

#### **B. Large Trader Reporting System**

MSD's principal tool for monitoring trading on the Exchange's various markets is NYMEX's Large Trader Reporting System ("LTRS"). The system contains data showing the positions held on the Exchange by all reportable traders, as that term is defined by Commission regulations and NYMEX rules, for each trading day from December 1999 to the present. The Exchange requires all clearing members, FCMs, and foreign brokers to provide close-of-business position data for all reportable traders to MSD by 8:00 a.m. the following business day.<sup>10</sup>

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<sup>9</sup> On March 17, 2008, NYMEX Holdings, Inc. and CME Group, Inc. entered into a merger agreement in which CME Group agreed to purchase NYMEX for \$9.4 billion in cash and shares. Once the parties submit to the Department of Justice all information required by law, there is a waiting period before the transaction may be completed. At the conclusion of its review, DOJ may determine to take no action if the merger goes forward, or may seek a federal court injunction barring the merger as anticompetitive.

<sup>10</sup> NYMEX Rule 9.33 requires omnibus accounts and foreign brokers to submit a signed reporting agreement to MSD, confirming that the omnibus account or foreign broker will report daily to the Exchange all customers that own or control positions which equal or exceed Exchange customer reporting levels. An omnibus account or foreign broker who fails to submit a signed agreement or to report positions as required by Exchange rules is subject to a hearing by the Business Conduct Committee to limit, condition or deny access to the market.

Virtually all of this data is transmitted directly to LTRS by electronic data feed.<sup>11</sup> LTRS also receives the details of each cleared trade through a feed from the Exchange's clearing system.

The LTRS database also includes all information contained in the copies of CFTC Form 102 ("Identification of Special Accounts") filed with the Exchange. NYMEX requires clearing members, omnibus accounts and foreign brokers to identify each account which exceeds reportable levels, by filing a Form 102 for that account with MSD within one business day of the first time the account becomes reportable, and to update each such form within one business day of any material change in the information it contains.<sup>12</sup> The form provides information on the account's ownership and control, and identifies futures and options traders who trade for the account.

MSD assigns a unique LTRS identification number to each trader who becomes reportable. LTRS uses this identification number to aggregate the trader's positions across different accounts at multiple clearing members. MSD also assigns a group identification number to entities that are affiliated, and LTRS uses this number to aggregate the positions of all related affiliates.

Since the 2003 Review, NYMEX has added a number of new or upgraded electronic surveillance tools to LTRS that are designed to enhance MSD's monitoring of the Exchange's markets. Use of these tools in combination with traditional market surveillance techniques increases MSD staff members' efficiency.

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<sup>11</sup> In instances where interruptions in computer service prevent normal data transmission, NYMEX requires that the data be scanned and emailed to the Exchange, because email provides an electronic audit trail concerning the time of submission. At the time of the 2003 Review, a significant quantity of reportable position information was submitted on paper and required manual entry into LTRS.

<sup>12</sup> Form 102 is designed to comply with the provisions of Commission Regulation 17.01(b).

NYMEX's new Volumetric Report matches the account numbers associated with trades executed on the Exchange with the names of the market participants who own those accounts.<sup>13</sup> This speeds the surveillance process considerably by letting analysts see at a glance for whose benefit trades that require scrutiny were made. Each trading day's Volumetric Report ranks all NYMEX account owners by the volume of their trades for that day, aggregating volume in cases where one person or entity controls more than one account. Account owners are listed by name, or, where the owner name is not yet recorded for an account, by an identifier assigned by the clearing member involved. On a daily basis, MSD staff contact clearing members for each of the largest-volume accounts (those listed in the first two pages of the Report) which are not already identified by owner name, obtain the names of the account owners, and enter them into the system.<sup>14</sup> As a result of this incremental process, the Volumetric Report module in NYMEX's LTRS now includes owner names for the accounts responsible for more than 80 percent of the Exchange's total trading volume. This information is hyperlinked to NYMEX's electronic trade register, known as the StreetBook, and to all of the Exchange's various electronic market and trade practice surveillance systems. As a result, compliance staff using any of these systems for market or trade practice surveillance can obtain the owner name for most accounts immediately by simply hovering a computer mouse over the account number. Using the Volumetric Report, an analyst examining a volume spike in a given market can zero in quickly on the high-volume traders whose trading may be of particular interest.

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<sup>13</sup> For these purposes, the Volumetric Report also records the names of persons or entities that control the accounts listed.

<sup>14</sup> Exchange staff initiated development of the Volumetric Report and began the process of gathering and retaining names of account owners in response to the Division's recommendation in the 2003 Review that the Exchange modify its program for review of Exchange of Futures for Physicals ("EFP") transactions to ensure regular review of an adequate number of EFPs and improve the timeliness of inquiries and investigations involving such transactions.

Analysts' access to information about account owners is also speeded by a new LTRS module that gives MSD staff immediate access to the information provided on copies of CFTC Form 102 filed with NYMEX by reporting firms to identify the owners of accounts holding positions large enough to be reportable as large traders. Form 102 filings, which used to be made in paper form and required keypunching by Exchange staff, are now made by electronic transmission directly into LTRS. The Form 102 module provides electronic access both to new Form 102s filed in electronic form and to scanned copies of older Form 102s filed in paper form.

The Exchange's new Look-Back Report ("LBR") is an enhanced version of the traditional LTRS report that listed the holders of long and short positions in each contract as of the end of each month, ranked by position size. The new version of the LBR allows analysts and investigators to select any trading day, and view long and short position holders in any contract, ranked by position size, for that day and the four days preceding it. The report can also be configured to look forward five days from a selected trading day. The LBR allows MSD staff to track position changes and trading strategies. It is particularly useful in monitoring long and short positions during contract expirations. Because the LBR also shows each position holder's trading volume for the day, it is also useful in tracking the trading of major position holders who swing from one side of the market to the other.

A similar ranking of customers, in this case by volume, is provided by the Exchange's new Customer Ranking Report ("CRR"), which draws trade volume data from the NYMEX StreetBook. The CRR aggregates positions of the same customer across different accounts, even in cases where different accounts are cleared by multiple clearing members, and enables MSD staff to determine rapidly who has traded the most significant volumes in any given NYMEX product.

Analysts can now view changes in any customer's position in any NYMEX product during any selected trading day by using a new LTRS tool called Position Movie, which draws its data from the NYMEX StreetBook. This gives MSD practical ability—something it lacked when a time-consuming, manual process was required—to detect intraday position limit violations, even in cases where the customer has come into compliance by the end of the day. It also enables detection of various types of intraday attempts to manipulate a market, for instance through trading at settlement (“TAS”) trades, or simultaneous reporting of large numbers of EFRPs on one side of the market. Position Movie data is readily transferable to an Excel spreadsheet, where it can be used to generate informative graphs.

LTRS also continues to provide traditional exception reports that identify trading that may merit additional scrutiny by analysts. The Futures Open Interest Exception Report and Options Open Interest Exception Report identify the percentage of open interest held by each customer with positions exceeding the report's parameters. The Spot Month Customer Net Position Limit Report and the Any/All Month Net Position Limit Exemptions Report identify customers who have exceeded position limits, hedge exemption limits, or accountability levels. The Unmentioned Exception Report shows any difference between an omnibus account's reported positions and those reported for it by its clearing member, while the Unreported Exception Report shows any difference between a clearing member's open interest and reportable positions. Reports concerning aggregated affiliates identify both the aggregate entity and the individual entities making up the aggregate.

Each analyst conducts daily review of the various LTRS reports concerning the contracts for which he or she is responsible. To enhance detection of potential position reporting problems, the Senior Director meets weekly with each MSD analyst to review large trader

exception reports for that analyst's assigned contracts. The meetings are held to ensure that each analyst is properly interpreting LTRS data and taking appropriate action when warranted.

MSD estimates that during the target period, review of large trader reports generated more than 90 percent of the market surveillance inquiries opened by MSD.<sup>15</sup>

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

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

Each MSD analyst is responsible for monitoring market developments, changes in both futures and cash prices, and spread relationships in each of his or her assigned markets. The principal electronic tool analysts use for these purposes is the Bloomberg News Service, which provides real-time news and cash market prices, and the ability to chart historical price relationships for various markets. In addition, staff can consult the Exchange's computerized record of historical Exchange prices, called the price data sheet, and can research market news on the Nexis computer database. Analysts also obtain price information and news from trade publications such as Petroleum Intelligence Weekly, Platts Gas Daily, Platts Oilgram, Platts Metals Weekly, Nefte Compass (a weekly publication on oil and gas in Russia, the Caspian region, Central Asia, and Eastern Europe), and American Metal Market, as well as from major financial news publications, including The Wall Street Journal, New York Times, and Financial Times. In addition to consulting computer and print data sources, MSD also conducts frequent telephone interviews with both cash and futures market participants and with industry analysts in order to compare price data, analyze the supply and demand components of the market, and identify unusual or abnormal price relationships.

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<sup>15</sup> Inquiries and investigations are discussed below at pages \_\_\_-\_\_\_.

MSD analysts also review the previous trading day's volume and open interest for their assigned contracts on a daily basis. Volume data for all contracts, compiled by the Exchange's Research Department, is available to analysts online, and can be sorted by contract and trade type as desired. Analysts obtain open interest data from the Daily Open Interest Reports generated by the Exchange for both futures and options. These reports display both open interest for a given trade date and the change up or down from the previous trade date. Analysts can also review what percentage of open interest is represented by the positions of individual large traders, by consulting the open interest exception reports for both futures and options generated by the Large Trader Reporting System. In addition, analysts can consult the Exchange's daily "Futures CFTC Report," which lists each clearing member's long and short positions and total open interest in each NYMEX futures contract for the previous trading day. In situations where historical data is needed, analysts can obtain complete Exchange price, volume, and open interest data for any date from 1986 to the present, in sortable Excel spreadsheet form, from the Exchange's Statistics Department.

In addition to reviewing volume and open interest data for completed trading days, analysts can also review intra-day volume data for all NYMEX contracts through the NYMEX Trade Matching System ("TMS"), and can view a current "snap shot" of the positions of any NYMEX clearing member via open interest reports available from the Exchange's clearing system.

For each physically settled contract, the analyst with monitoring responsibility maintains data collected during routine daily surveillance in a spreadsheet known as the "cash sheet" for that commodity. Cash sheets record information on daily volume, settlement prices and open

interest, comparisons of spot and second nearby month futures prices, cash market prices, and historical spread differentials.

## **2. Deliverable Supply For Physically Delivered Commodities**

MSD monitors deliverable supply for energy products, in part, through data obtained from the Department of Energy, the Energy Information Administration, and the American Petroleum Institute. MSD staff also contact clearing members and large traders directly with deliverable supply inquiries relating both to upcoming contract expirations and to general market conditions. Similar inquiries are made to cash and voice brokers and large commercial customers such as major oil companies. Analysts then compare the information obtained with supply information available through Bloomberg and other research services.

For metals contracts, MSD monitors deliverable supply through the daily reports on warehouse stocks which the Exchange requires from each approved metals warehouse. Each daily report lists the amount in the warehouse on the previous day, any amounts received or withdrawn, the net change, and the resulting total stock for the day in question. Analysts examine these reports on a daily basis for indications of sudden or trending shifts in the availability of deliverable supply and the ownership of deliverable stocks, and retain the information in spreadsheet form.<sup>16</sup>

## **D. Surveillance of Expiring Contracts**

### **1. Standard Procedures For Heightened Surveillance**

MSD heightens surveillance of expiring contracts in order to detect and prevent price manipulations and facilitate orderly liquidations. Heightened surveillance typically begins one, or in some cases, two months before contract expiration, and is continued during the delivery

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<sup>16</sup> The information obtained is also made public through the Exchange's Corporate Communications Department, which posts it on the Exchange's web site and disseminates it to various news services.



month. Analysts conduct daily review of the trading and positions of large traders, in light of the current state of open interest and of the size and ownership of deliverable supply for physical delivery contracts. They also monitor cash market prices, supplies, transportation rates, cost of carry, and other factors that could affect an orderly liquidation. In addition, staff analyze unusual short supply indications, atypical spread and basis relationships, abnormal price relationships among cash, futures and options markets, and other unusual market circumstances that could raise the potential for a liquidation problem. MSD conducts frequent telephone interviews with cash and futures market participants to obtain current information on their positions, economic strategies, and delivery intentions or other liquidation plans, and to advise market participants of their responsibilities to assure an orderly liquidation. MSD staff also routinely share information concerning contract expiration issues with Commission staff.

MSD routinely gives special attention to monitoring expirations of Exchange futures contracts in platinum and palladium, because their supply is limited and expiration problems can arise if stocks in depositories are low. Throughout the two months prior to expiration, MSD staff maintains a dialogue with clearing members to remind them of their customers' obligations respecting orderly liquidations and inquire concerning customers' intentions. If a platinum or palladium market participant does not intend to make delivery or lacks the capability to do so, MSD requires that the participant liquidate its position in an orderly manner or roll the position forward to a later contract month, and MSD then monitors the liquidation or roll.

MSD also gives particular scrutiny to potential delivery congestion problems that could arise in connection with expirations in its two New York Harbor contracts, heating oil and gasoline. Deliveries on both of those contracts occur out of the same harbor terminals within various five-day windows. During the expiration month, the Exchange requires all short position

holders to notify the Exchange of which terminal(s) they plan to use for delivery. MSD records this data in an Excel spreadsheet in order to compare it with the physical capacity of the terminals, and contacts position holders immediately to resolve potential physical congestion issues.

MSD maintains all data reviewed by analysts during surveillance of an expiring contract in an expiration “control file.” Control files normally include price charts, volume and open interest data, warehouse stock reports, news articles, and notes of conversations with customers and clearing members. The Division reviewed 20 representative control files across NYMEX markets, and found that each contained appropriate data, correspondence and information.

Information gathered in control files is shared with members of the Exchange’s Control Committee whenever MSD determines that a potential expiration problem exists. The Control Committee is responsible for correcting any circumstances which could interfere with the normal functioning of the market.<sup>17</sup> A Control Committee Subcommittee of three members is appointed for each contract traded on the Exchange. MSD convenes a meeting of the relevant subcommittee whenever necessary to address potential contract expiration or other market problems. Such meetings are attended by the analyst responsible for the contract as well as by MSD supervisory personnel. The Subcommittee reviews information concerning the largest long and short position holders and their delivery intentions, as well as data on open interest, volume, price, spread differentials, deliverable supply, cash market data, comparable historical data, and

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<sup>17</sup> Under NYMEX Rule 3.17, circumstances which might interfere with the normal function of the market include: “events, conditions or positions which threaten or might threaten a free, open and orderly market, the fair and orderly trading in any commodity futures or options contracts, the orderly liquidation of any commodity futures or options contract or delivery pursuant to any futures contract; a distortion of prices; a congestion, squeeze or corner or circumstances or positions which might result therein; positions of any person or group of persons which might lead to any of the foregoing results or which are out of proportion to his or their ability to perform their contracts; or any events, and, circumstances or positions which threaten or might threaten the best interests of the Exchange or the public.”

any other factors potentially affecting the market. The Subcommittee has the authority to assemble information on open positions at any time, and can require any member or member firm to provide requested information or allow examination of its books and records.<sup>18</sup>

After expiration of a contract involving physical delivery, MSD also monitors the delivery process. MSD maintains contacts with market participants to ensure that delivery instructions are submitted in a timely manner and that deliveries proceed according to Exchange rules and procedures. If potential delivery issues warrant, MSD can convene the Exchange's Delivery Committee to oversee the situation.

During the target period, contract expirations in most Exchange products did not involve significant problems. MSD did not find it necessary to convene any meetings of either the Control Subcommittee or the Delivery Committee. However, expirations in two products, unleaded gasoline and natural gas, required additional scrutiny due to particular circumstances, as described below.

## **2. Target Period Expirations In Unleaded Gasoline**

Several unleaded gasoline contract expirations during the target period required particular scrutiny by MSD, due to special circumstances created by the nationwide phase-out of methyl tertiary-butyl ether ("MTBE"), an additive previously used in Reformulated Gasoline ("RFG"), but discontinued due to environmental protection concerns. As part of this phase-out, the Energy Policy Act of 2005 ("2005 Act") and the Environmental Protection Agency regulations associated with it provided for reduction of the supply of RFG in New York Harbor as of May 6, 2006, and termination of all New York Harbor deliveries of RFG as of January 30, 2007. This obliged NYMEX to phase out its New York Harbor Gasoline ("HU") futures contract, which

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<sup>18</sup> See NYMEX Rule 3.17(E).

specified New York Harbor deliveries of RFG containing MTBE, by December 29, 2006, the last trading day for the January 2007 HU contract. The situation required careful, non-routine monitoring of the liquidation of the substantial existing open interest in the HU contract. It also required careful handling of the expected shift of much of that open interest into NYMEX's new futures contract in reformulated gasoline blendstock for oxygen blending ("RBOB"), the new MTBE-free, ethanol-containing form of unleaded gasoline required by the 2005 Act.

MSD took a number of steps to ensure the orderly functioning of its markets during the transition from the old to the new form of gasoline. To give advance notice that would smooth the transition process, NYMEX notified Exchange members on March 24, 2006, that (a) it would not list additional months in the HU contract—normally listed for 12 successive months on a rolling basis—beyond January 2007, and that (b) it would begin listing 12 successive months in the RBOB contract and maintain 12 months of RBOB listings on a rolling basis going forward.

Due to the anticipated May 6, 2006, reduction in the New York Harbor supply of RFG as mandated by the 2005 Act, on April 10, 2006, the Exchange notified all parties holding hedge exemptions from position limits in the HU contract that all existing HU hedge exemptions would be terminated as of April 30, 2006, the last trading day for the May 2006 HU contract. In order to facilitate shifting of open interest from HU to RBOB, NYMEX also advised position holders on April 10 that their HU hedge exemption limits would be replicated in the RBOB contract from April 10 through April 30, 2006, and that they would be permitted to maintain concurrent HU and RBOB exemptions during that period.

As the New York Harbor RFG supply reduction continued, on May 26, 2006, the Exchange reduced its HU spot month speculative position limit from 1,000 net contracts to 250 net contracts, effective for the last three trading sessions for the July HU contract and the last

three sessions for all remaining HU expirations. As the phase-out proceeded, NYMEX granted a total of 29 temporary, single-month hedge exemptions from these reduced speculative position limits in order to accommodate legitimate commercial needs of entities attempting to fulfill business obligations involving deliveries of RFG outside the United States which were covered by hedge positions in the HU contract. The Division reviewed each of these exemptions, and found that they were granted on the basis of commercial needs appropriately documented in NYMEX's exemption files.<sup>19</sup>

During the final months of the HU contract, MSD took two steps to further heighten the normally elevated scrutiny of floor trading on the final trading day for the expiring contract. First, MSD activated surveillance cameras covering the HU pit for the entire last trading day, and notified all traders that it was doing so. Second, in coordination with Exchange Compliance Department trade practice surveillance staff and the Exchange's Floor Committee, MSD increased the number of staff present in the pit to physically observe trading throughout the final trading day, beyond the number normally attending expirations.

In the end, the expirations of the final months of the HU contract unfolded without significant problems.<sup>20</sup> MSD did not find it necessary to convene either the Control Committee or Delivery Committee in this connection.

### **3. Target Period Expirations In Natural Gas**

A number of natural gas futures contract ("NG") expirations required expanded scrutiny by MSD during the target period, due to significant price volatility and high trading volume in

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<sup>19</sup> The Exchange's hedge exemption process is discussed below at pages \_\_\_-\_\_\_.

<sup>20</sup> MSD did observe notable price spikes on the final trading day for both the November and December HU contracts, which by then involved fairly illiquid markets. Analysts reviewed the trading surrounding these spikes, which involved individuals trading for their own accounts rather than commercial customers. They found no violations of Exchange rules, and determined that the price movements involved were of the sort that is normal for expiration months in illiquid markets when some participants have remained in the market until the final trading day.

the entire U.S. market for natural gas. In the course of the target period, two large hedge funds that traded heavily in NG futures experienced significant losses that led to their eventual collapse. As a result, trading on NYMEX's natural gas futures market received an unusual degree of public attention, including Congressional hearings.

The task of monitoring potentially problematic NG contract expirations was complicated for MSD by the fact that, in the current natural gas market environment, MSD cannot routinely see or conduct surveillance concerning the entire natural gas position held by a given market participant. Since a successful product launch during the target period, ICE Atlanta, a NYMEX competitor, has maintained significant volume in electronic trading of OTC natural gas products linked to, and cash settled on the basis of, NYMEX's NG contract. Because ICE Atlanta's electronic trading facility for these products qualifies as an Exempt Commercial Market under the Act, trading on that facility is exempt from most Commission regulation.<sup>21</sup> These facts prevent NYMEX from seeing the full extent of market participants' natural gas positions, if they hold positions in the linked ICE Atlanta contract.

During the target period, the Commission opened investigations into NG trading by market participants whose trading activity was already under review and investigation by MSD analysts. MSD cooperated with these investigations by providing contract expiration information, LTRS records, case files, and other related data. Due to these Commission investigations, MSD suspended its own investigations into the trading involved, while continuing its regular monitoring of NG trading, heightened scrutiny of potentially problematic NG contract expirations, and cooperation with Commission staff. Because some Commission investigations are still ongoing, and others have resulted in charges and pending court cases, this report does

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<sup>21</sup> See § 2(h)(3) of the Act.

not discuss most particulars of those matters or draw conclusions concerning them. Rather, the report's focus is on MSD's process for handling expiration-related market conditions and trading of the sort it encountered in its natural gas market during the target period.

MSD detected the problems that arose during the target period in NG trading through its regular, daily monitoring of position accountability levels, spot month position limits, and the trading and positions of large traders. NYMEX's reviews and investigations of the trading involved were initiated as the result of this process, not as the result of referrals from outside sources. When potential problems were detected, MSD followed its usual practice of maintaining frequent contact with the market participants involved concerning position accountability, applicable position limits, and the participants' responsibilities with respect to contract expirations. In addition, MSD discussed the financial risks involved in potentially problematic natural gas positions during meetings held as part of a new NYMEX financial oversight program involving regular visits to clearing members to review their risk evaluations of large traders in comparison with NYMEX's own risk evaluations. MSD also followed its normal practice of sharing information relating to its reviews and investigations with Commission staff.

At the conclusion of the target period, the Compliance Department undertook a "lessons learned" review of issues it had encountered in natural gas trading. As a result of this review, NYMEX took a number of significant steps to further improve its process for handling similar issues.

Several of these steps involved added scrutiny of large positions in back months. During the target period, some natural gas market participants had held unusual and relatively unprecedented levels of open interest in back months of the NG contract. The futures-only

positions involved would have been seen earlier as presenting potential problems but for the fact that NYMEX's normal calculation of back month position size relative to position accountability levels included aggregation of—i.e., offsets for—futures equivalents which were cash settled on the basis of the price of the futures contract involved. In the case of natural gas, this meant that futures positions were offset by, among other things, positions in NYMEX's natural gas swap contract (“NN”), which is cash settled on the basis of the NG futures contract. This had the effect of partially obscuring the size of a participant's futures-only position in a back month, relative to total open interest in all futures and options months on a combined basis.

As a result of its “lessons learned” review, NYMEX made several notable adjustments and additions to its rules and procedures relating to position size monitoring, designed to enhance early detection of potential problems indicated by the size of various types of positions, including back month positions and futures-only positions. NYMEX lowered its single-month position accountability levels for all of its physically delivered core contracts, including natural gas, crude oil, heating oil, gasoline, and metals. Exchange rules now provide that position accountability and the increased scrutiny that it brings can be triggered by the size of a market participant's futures-only position, as well as by the size of the participant's overall combined position. NYMEX also specifically disaggregated the NG and NN contracts, so that NN positions that offset NG positions do not obscure NG position size. Exchange rules now also provide that position accountability can be triggered by an any-one-month position, as well as by an all-months-combined position. The position-size-calculation modules of the Exchange's LTRS have been reprogrammed to reflect these changes. LTRS now produces a futures-only position size report in all of NYMEX's physically delivered core contracts. For all months with significant levels of open interest, the report flags all futures-only positions that are greater than



30 percent of the open interest in that month. MSD analysts give increased scrutiny to all market participants who reach this threshold. In addition, analysts contact all traders whose futures-only positions reach 25 percent of open interest in a given month, to warn them that they will receive greater scrutiny if they reach the 30 percent threshold.

In addition to these changes to rules and procedures, NYMEX initiated a program of weekly meetings between senior Compliance Department staff in market surveillance and trade practice surveillance and the Exchange's senior staff in risk analysis and financial surveillance, to review futures-only concentrations existing in back months as well as spot months. In addition to their normal daily reviews, MSD analysts now focus additional weekly review on concentrations in back months, in preparation for this meeting.

NYMEX also took steps to further improve its scrutiny of Trading At Settlement ("TAS") trades, another area in which potential problems were encountered during the target period.<sup>22</sup> In the course of their daily market reviews, MSD analysts now use the LTRS Volumetric Report to identify market participants on either side of a market who hold large positions in TAS trades as well as in outright trades or EFRP transactions. They then review trading by those participants during the closing range and throughout that trading day for possible improper trading intended to move the settlement price in order to profit through the TAS trades. MSD is in the process of developing an LTRS report that will automate the manual process of comparing traders' TAS trade rank order by volume with their trading activity during the closing range.

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<sup>22</sup> In a TAS trade, a market participant enters into a transaction prior to the day's closing range for the commodity in question, and agrees that the transaction price to be paid will be that day's settlement price, which is set by trading during the closing range (typically the last two minutes of the trading day). Since various OTC energy swaps and other OTC products are priced by reference to the NYMEX settlement price for the relevant commodity, TAS trades can provide an exact price hedge for market participants who have financial exposure in such products.

Finally, NYMEX also moved to address—to the extent it could do so—its inability to see the entire natural gas position held by an NG market participant, resulting from the fact that an NG participant may also hold a position, invisible to NYMEX, in competing natural gas products on other markets, such as ICE Atlanta, that are linked to and cash settled on the basis of NYMEX’s NG contract. Shortly after the end of the target period, NYMEX put in place a rule provision, going beyond those in place at any other designated contract market, that require NG market participants holding an NG position of more than 1,000 contracts prior to the NG market open on the last trading day of each NG expiration to disclose to NYMEX their complete book of all positions, wherever held, that are linked to the settlement price of the expiring NG contract.<sup>23</sup> The rules require that the participant’s NG position in excess of 1,000 contracts must offset a demonstrated risk in its complete natural gas position book, and require that the net exposure of the entire book must not exceed 1,000 contracts on the side of the market that could benefit if the participant’s trading during the closing range affects the final settlement price. Any position that does not meet these tests must be reduced to a maximum of 1,000 contracts before the start of the closing range on the last trading day.<sup>24</sup>

The Division believes that NYMEX has an adequate and appropriate process for handling expiration-related market conditions and trading of the sort that occurred in the natural gas market during the target period. The Division notes that MSD’s procedures resulted in early detection of the potential problems involved in this trading, and that the Exchange took responsive steps including contact with market participants concerning position accountability, additional review of trading and the opening of investigations. The Division also notes that the

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<sup>23</sup> NYMEX Rule 9.27A(D), and NYMEX Compliance Advisory #01-07 – Policy Statement Related to Exemptions from Position Limits in NYMEX Natural Gas (NG) Futures Contracts.

<sup>24</sup> After NYMEX imposed this requirement, its NG expiration day volume decreased significantly, and natural gas volume at ICE Atlanta increased.

Exchange conducted the sort of “lessons learned” review that a self-regulatory organization should conduct when it encounters issues of this magnitude, and took a number of initiatives to further improve its related rules and market surveillance processes. As a result, recommendations that the Division might have made with respect to these matters have already been undertaken by the Exchange.

## **E. Position Accountability Levels, Position Limits and Hedge or Swap Exemptions**

### **1. Position Accountability Levels and Position Limits**

At NYMEX, the size of market participants’ positions is subject to two types of monitoring and control: position accountability levels, and position limits. A position accountability level can be thought of as a threshold that triggers additional scrutiny of a position by MSD and gives MSD certain powers to address potential market problems. NYMEX has all-months-combined and any-one-month position accountability levels for all of its contracts. To determine position size, the Exchange nets long and short futures positions, and converts option positions to their futures equivalents. When the size of a market participant’s net position in a given contract in any single month, or in all months taken together, reaches or exceeds the applicable position accountability level, Exchange rules require the participant to provide various types of information to the Exchange at its request, including information about the participant’s trading strategy and the nature or purpose of the position (e.g., speculation, hedging, or involvement in a swap or spread).<sup>25</sup> Holding a position that exceeds a position accountability level is a normal occurrence and not in itself a rule violation. However, Exchange rules give the Compliance Department authority to direct a participant to limit or reduce any position where the

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<sup>25</sup> See NYMEX Rule 9.26 (“All Month/Any One Month Position Accountability”).

Exchange determines this to be necessary, and a participant's refusal to comply with such a directive would be a rule violation.<sup>26</sup>

NYMEX's position limits, which apply at specified points during the expiration month of the contract in question, bar a market participant from holding or controlling a net futures equivalent position in that month which exceeds the position limit specified by the Exchange for that contract, as adjusted in individual instances by a hedge or swap exemption granted to the participant by the Exchange.<sup>27</sup> NYMEX imposes position limits on all contracts involving physical delivery.<sup>28</sup> Position limits for energy contracts apply throughout the last three trading days of the contract's expiration month (e.g., during the last three business days of April with respect to the May heating oil contract).<sup>29</sup> Position limits for metals contracts apply throughout the expiration month and during the last two business days of the preceding month (e.g. during the last two business days of March and throughout April for the April platinum contract).<sup>30</sup> Exceeding a position limit without previously having obtained an exemption or obtaining a temporary exemption at the time is a rule violation.<sup>31</sup>

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<sup>26</sup> NYMEX Rule 9.27A. In general, determination of what constitutes an unacceptably large futures position involves two interacting factors: percentage of open interest and time to expiration. Normal market behavior produces increasing liquidity in a contract as the spot month approaches, followed by decreased liquidity immediately prior to expiration as positions are either liquidated or rolled. While it might be natural for one market participant to have a relatively high percentage of open interest in a back month when liquidity is normally low and time to expiration is long, in nearby months and early in the spot month, when open interest is highest, the percentage of open interest held by one market participant should not be extraordinarily high. Failure to decrease position size as expiration approaches can also signal potential liquidation problems or possible trading violations.

<sup>27</sup> See NYMEX Rule 9.27(B) and (C). The exemption process is discussed below at pages \_\_\_-\_\_\_.

<sup>28</sup> Some financial products that are cash settled and do not involve any physical delivery do not have position limits.

<sup>29</sup> For energy contracts, trading terminates at or near the end of the month preceding the delivery month, referred to as the expiration month. For metals contracts, trading terminates three days before the end of the delivery month.

<sup>30</sup> See NYMEX Rule 9.27. The limits for uranium and PJM electricity contracts apply throughout the expiration month.

<sup>31</sup> NYMEX Rule 9.27.

## 2. Exemptions From Position Limits

Although both hedgers and speculators who hold expiration month positions are subject to the Exchange's position limits, a market participant that qualifies as a bona fide hedge or swap participant with a need for higher position limits can obtain an exemption that effectively raises the applicable limit for that participant, by filing an exemption application or hedge notice.<sup>32</sup> In addition to filling out the application, the applicant must provide to the Exchange a description of its commercial operations, corporate and subsidiary structure, financial status, and risk management programs, and a statement explaining its need for the exemption, together with supporting documentation.<sup>33</sup>

The Exchange grants exemptions separately for long and short positions for each commodity. Decisions on whether to grant a requested exemption and the size of the exemption to be granted are based on a market participant's demonstration of its commercial need for the exemption and its financial ability to carry such a position through the delivery process, as well as on MSD's analysis of open interest, deliverable supplies, and delivery capacity with respect to the commodity in question. After MSD staff verify the information submitted, applications are reviewed by the Senior Director of Market Surveillance before a final decision as to approval is made by the Chief Regulatory Officer. Most exemptions are effective for one year and cover all contract expirations occurring during that year for the commodity involved. Once an exemption

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<sup>32</sup> See NYMEX Rules 9.28 (Exemptions from Position Limits for Bona Fide Hedging Transactions) and 9.29 (Exemptions from Position Limits for Exposure from Commodity Swap Transactions).

<sup>33</sup> Exchange rules permit applications to be filed up to five days after a position exceeds the limits with regard to NYMEX contracts other than metals contracts, but require that an application be filed and approved before limits can be exceeded with respect to COMEX contracts. The Exchange President or his designee may authorize the late filing of a hedge notice in special circumstances.

expires, reapplication is required for exemption renewal. Exchange rules permit the Exchange to revoke, modify, or limit an exemption at any time.<sup>34</sup>

Each month, the Exchange generates a hedge exemption register that lists all entities granted an exemption for each commodity, together with the exemption level and expiration date of each exemption. MSD also maintains a hedge exemption file for each exemption applicant, which contains the application and supporting documentation, MSD work papers, and the Exchange's written grant or denial of the application.

During the target period, MSD took action on 786 exemption applications.<sup>35</sup> MSD approved 128 new exemption applications, granted 279 applications for renewal or reinstatement of previous exemptions, approved six applications for increased limits, and denied 47 applications. MSD also granted 216 temporary exemptions for the current expiration month. Thirty exemptions were transferred from the HU gasoline contract to the new RBOB gasoline contract, as discussed above. Eighty exemptions expired or were terminated.

The Division reviewed 32 representative exemption files containing 180 exemption applications relating to all of the Exchange's core energy and metals contracts.<sup>36</sup> Generally, each file was well documented, containing a completed application, annual financial statements, position reports, other relevant correspondence, and MSD memoranda. Files also contained a one-page exemption summary that provides the applicant's contact information, a list of the applicant's previous exemptions and exemption requests, a short description of the applicant's

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<sup>34</sup> See NYMEX Rule 9.30(A).

<sup>35</sup> The 786 applications included 364 applications relating to NYMEX contracts, and 422 applications relating to ClearPort Clearing contracts. ClearPort Clearing is discussed below at page \_\_.

<sup>36</sup> The files reviewed included 87 applications for exemptions relating to NYMEX contracts, and 93 applications for exemptions relating to ClearPort Clearing contracts.

business, financial status and current exemption request, a statement of the Exchange's decision concerning the request, and the expiration date of the exemption, if granted.

However, the Division found that in several instances the exemption applicant did not appear to have demonstrated sufficient cash market or swap exposure to justify the requested exemption. Some files did not appear to document the applicant's hedge exposure at all, or contained documents whose nature and format made it difficult to determine whether the exemption request was justified, while other files showed exposure well below the level of the exemption granted. For example, in June 2006 a market participant sought year-long exemptions from position limits in heating oil, crude oil, and natural gas futures, and was granted exemptions up to 7,000 contracts each in crude oil and natural gas and up to 1,500 contracts in heating oil. However, neither the applicant's documents nor MSD's exemption summary sheet in the file indicated the level of the applicant's cash market or swap exposure.<sup>37</sup> In another example, in April 2006 a market participant sought a temporary spot-month exemption up to 3,000 contracts in both light sweet crude oil futures, which had a position limit of 2,000 contracts, and natural gas futures, which had a position limit of 1,000 contracts. MSD granted the requested temporary exemptions for an additional 1,000 contracts (1 million barrels) in light sweet crude oil and an additional 2,000 contracts (20 million MMBTUs) in natural gas, despite the fact that the participant's file only included documentation of exposure to OTC light sweet crude oil swaps totaling approximately 128,133 barrels and OTC natural gas options totaling approximately 3.6 million MMBTUs, far less than the amounts implied by the requested exemptions. In a third instance, a participant requested and received a temporary spot-month exemption for an

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<sup>37</sup> Although the application referred to attached spreadsheets, the spreadsheets did not appear to demonstrate physical commodity or swap exposure.

additional 1,500 natural gas futures contracts, although it had documented offsetting natural gas futures exposure on ICE Atlanta totaling only 598 contracts.

The Division also found that most applications for temporary, expiration-month-only exemptions did not include an application form completed by the market participant to substantiate the request. MSD informed the Division that during the target period, when market participants with fairly recent exemptions on file exceeded the limits of those exemptions and sought additional temporary exemptions, MSD allowed email correspondence to be substituted for a written exemption application. The Exchange began requiring written applications for all temporary exemptions in January 2007, after the conclusion of the target period.

Under Exchange rules, an exemption should be granted only on the basis of bona fide, demonstrated hedge or swap exposure for the market participant involved. The Division therefore recommends that MSD review its procedures for granting or denying exemption requests, and make adjustments as needed to ensure that all exemptions granted are based on the applicant's demonstrated cash market or swap exposure.<sup>38</sup> To help insure that this goal is met, MSD should include in all exemption files a work sheet showing how staff determined the appropriate exemption level to be granted, and should require all exemption applicants to complete an exemption application form.

### **3. Monitoring Of Position Accountability Levels And Position And Exemption Limits**

To monitor trading for instances where position accountability is triggered and for potential position and exemption limit violations, the MSD analyst assigned to each contract

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<sup>38</sup> The Division recognizes that, in some instances, a market participant's hedge or swap exposure may change from day to day or hour to hour, and that as a result it may be reasonable for a participant to request, and for the Exchange to grant, an exemption slightly higher than the participant's exposure existing at a particular point in time. One way to recognize this reality while upholding the principle that exemptions are granted only for hedge or swap exposure would be to instruct participants who receive an exemption that their position may not exceed the stated level of the exemption or their actual exposure at any applicable time, whichever is lower.



conducts daily review of a number of LTRS reports that identify all market participants whose positions have reached applicable accountability levels or have exceeded applicable position or exemption limits for that contract.<sup>39</sup> The analyst also uses LTRS ranking reports to identify both market participants holding large percentages of open interest and accounts that are approaching position or exemption limits.<sup>40</sup>

Whenever any of these reports reveal that a position has reached an applicable position accountability level (“PAL”), the analyst opens a PAL inquiry tracked in MSD’s Rule Violation Log.<sup>41</sup> After verifying the market participant’s position information through direct contact with the participant’s clearing member and cross-checking with other LTRS reports, the analyst assesses whether a position of the size involved is appropriate for that market participant and that market considering the market conditions and circumstances involved. The factors considered

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<sup>39</sup> The Spot Month Customer Net Position Limit Report lists market participants whose spot-month futures positions exceed position or exemption limits. The Any/All Month Net Position Limit Exemption Report lists participants whose any-month or combined all-months futures-equivalent positions exceed position or exemption limits, or have reached all-months accountability levels. The Customer Gross Position Limit-Options report notes all market participants whose all-months gross options positions in either put or call options exceed accountability levels. The Spot-Customer Net Futures Equivalents report identifies, by option contract, all participants whose current delivery month net futures-equivalent positions exceed position or exemption limits. The Futures Open Interest Exception Report and Options Open Interest Exception Report identify participants whose positions exceed a predetermined percentage (generally 20 percent) of open interest for any month or for all months combined.

<sup>40</sup> The Futures Customer Position Ranking By Contract report, the All Months Customer Position Ranking Report, the Customer Options Position Ranking By Underlying Contract report, and the All-Month Customer Options Position Ranking report list gross long and gross short positions for all reportable market participants for each contract month and for all months aggregated, and rank the accounts of all reportable traders in descending order by their net positions. For futures contracts with corresponding option contracts, analysts also obtain ranking information from the Customer Futures Equivalents Ranking Spot Month and All Months reports, which list all reportable traders in descending order by their futures-equivalent positions.

<sup>41</sup> As discussed below at pages \_\_-\_\_, MSD tracks its investigative activity in the form of both inquiries and investigations. Inquiries, which are less formal than investigations, are opened whenever an MSD analyst encounters a situation which needs further attention and examination or concerning which documents need to be requested. All inquiries are recorded in the MSD Rule Violation Log, with the exception of EFP or EFS inquiries, which are recorded in the EFP or EFS control sheet. Despite its name (retained for historical reasons), the Rule Violation Log includes position accountability inquiries that do not in themselves imply a violation, as well as position limit inquiries and inquiries into particular trading activity that may involve violations. This centralized tracking of all types of inquiries increases staff efficiency. MSD opens a formal investigation whenever it discovers possible violations of a serious nature, whenever an inquiry indicates a possible violation of Exchange rules which needs to be pursued further, or whenever a matter is referred by the Commission. Investigations are recorded in the Investigation Register.

include the participant's percentage of open interest and position ranking in relation to other participants in the market in question; the nature of the participant's business; the participant's capitalization and financial resources; and the degree to which the position is appropriately hedged. If the analyst determines, in consultation with a supervisor, that additional information is needed for adequate analysis of the situation, MSD contacts the market participant, either directly or through the clearing firm involved, for further information regarding the nature and size of the position and the participant's trading strategy.<sup>42</sup> The analyst then recommends what action, if any, should be taken by MSD. This may include adjusting the position accountability trigger in LTRS for that market participant, scheduling a follow-up review of the position, recommending that the participant file for a hedge exemption, barring further position increases, or instructing the participant to reduce or liquidate the position. After MSD determines the action to be taken, the analyst records the results in the comment field of the Rule Violation Log and conveys any needed instructions directly to the market participant.

MSD opened 236 position accountability inquiries during the target period. Based on its assessments of the positions and market participants involved, MSD raised the position accountability trigger for 203 market participants, decided in 32 instances that action was not required. The Division reviewed a random selection of 66 of the 236 PAL inquiries. It found that when accountability levels were reached, MSD responded promptly, almost always on the same day, by contacting the customer to obtain the information required under Exchange rules, and that MSD made appropriate and timely decisions regarding responsive action.

MSD also opens an inquiry or investigation that is tracked in the Rule Violation Log whenever daily review of LTRS reports indicates that a market participant may have violated

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<sup>42</sup> Under NYMEX Rule 9.26(A), failure by the participant to supply any requested information can trigger an immediate Compliance Department bar on further position increases or an order to reduce or liquidate the position.

Exchange rules by holding a position that exceeds an applicable position or exemption limit.

The analyst conducting the inquiry verifies the participant's position information, and checks all hedge exemptions on file for the participant. If the position exceeds the position limit, as modified by any applicable hedge exemption, MSD immediately notifies the participant that the limit has been exceeded. Unless within five business days the participant seeks and is granted a temporary hedge exemption for the month in question, MSD will order the participant to reduce the position below the level of the applicable limit.<sup>43</sup>

Exchange rules provide for sanctions for position or exemption limit violations.<sup>44</sup> An Exchange member's first limit violation will result in issuance of a warning letter, while a second offense within 12 months will result in a summary fine of \$1,000 and a cease and desist order, and a second offense more than 12 months after a first offense will result in a cease and desist order. A non-member market participant's first limit violation will result in a warning letter, while a second violation at any time will result in issuance of a warning that any future violations of position limit and exemption rules may result in extraordinary sanctions including the conditioning, limitation, or denial of access to the market. The Exchange may bring disciplinary proceedings before the Business Conduct Committee and impose additional penalties up to and including denial of access to the market whenever a limit violation by any market participant occurs in the spot month, exceeds position or exemption limits by more than 150 percent, is a third offense within any 12-month period, or is deemed by the Exchange to be a severe abuse of its rules. In addition, clearing members are subject to all of the sanctions noted above for each

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<sup>43</sup> See NYMEX Rule 9.28(B).

<sup>44</sup> See NYMEX Rule 9.36.

instance when one of their customers exceeds position or exemption limits as of the close of trading on two successive trading days.<sup>45</sup>

During the target period, MSD opened 405 inquiries into possible position limit and exemption limit violations.<sup>46</sup> Violations were found in 36 inquiries. Thirty-two warning letters were issued for first offenses. MSD issued a second warning letter and imposed a \$1,000 summary fine for a repeat violation by one Exchange member, and issued second warning letters for repeat violations by two non-member market participants. Two hundred five inquiries resulted in issuance of temporary exemptions. The remaining 164 inquiries did not disclose violations, and were closed without further action.<sup>47</sup>

Two target period inquiries evolved into investigations. One investigation resulted in disciplinary action against an Exchange member who exceeded position limits on a third occasion within twelve months, after he had received a warning letter for a first position limit violation and a second warning and a summary fine for a second offense. The disciplinary proceedings were concluded by a settlement providing for a \$5,000 fine and an order directing the member to cease and desist from further violations. Another investigation was suspended when the trading involved became the subject of a Commission investigation. MSD also continued two additional investigations begun prior to the target period, closing one with issuance of a warning letter, and suspending the second when that matter became the subject of a Commission investigation.

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<sup>45</sup> A clearing member with discretionary authority over a customer account can be sanctioned if the account exceeds position or exemption limits as of the close on a single trading day.

<sup>46</sup> This represents a substantial increase over the 67 position limit violation inquiries opened during the target period for the 2003 Review. The exemption process is discussed above at pages \_\_\_-\_\_.

<sup>47</sup> Typically, in these inquiries MSD found that the positions under review were covered by exemptions, or that no violation was present after the Exchange took into account particular factors such as changes in option deltas, timing of options processing, or offsets for cash-settled European-style options contracts.

The Division reviewed all 34 position limit inquiries in which warning letters were issued and a random sample of 70 additional inquiries, and reviewed all of the position limit investigations.<sup>48</sup> The Division found that MSD addresses potential violations in a timely fashion and that files were well documented. In general, the Division also found that MSD followed the sanctioning process laid out in Exchange rules, by issuing warning letters for first offenses, imposing a fine as well as issuing a warning letter for a second offense by a member within 12 months, and bringing disciplinary charges and imposing appropriate sanctions where a member had a third violation within 12 months.

However, the Division believes that the Exchange did not appropriately apply its position and exemption limit rules when two non-member market participants each violated position and exemption limits on two occasions during the target period. Exchange rules authorize the Compliance Department to bring a disciplinary action before the BCC against any market participant, whether member or customer, and to impose additional penalties, for any instance when a market participant, among other things, exceeds position or exemption limits during the spot month, holds a position greater than 150 percent of the applicable limits, or commits what the Compliance Department deems a severe abuse of Exchange rules.<sup>49</sup> The penalties available in such a case can include limiting, conditioning or denying access to the market. During the last three trading days for one expiring natural gas contract, when the 1,000-contract position limit in natural gas had been raised for one market participant to 2,500 contracts by a 1,500-contract exemption, that participant's position grew to 3,646 contracts, 145 percent of the applicable limit. During the last three trading days for a subsequent natural gas contract expiration, when

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<sup>48</sup> Because two of the investigations had become the subject of ongoing Commission investigations, the Division's review of those investigation files was limited.

<sup>49</sup> NYMEX Rule 9.36(E).

the same market participant again had an exemption limit of 2,500 NG contracts, the participant's position in that expiring contract swelled to 8,488 contracts, 339 percent of the applicable limit.<sup>50</sup> The Exchange did not bring disciplinary charges before the BCC, issue a cease and desist order, or limit or condition the participant's market access, but only issued warning letters, despite the fact that the participant's violations had occurred during the spot month, had involved positions far in excess of 150 percent of the applicable limit, and could certainly have been deemed a severe abuse of Exchange rules. Moreover, the decision not to seek additional sanctions for the participant's second violation came at a time when the Compliance Department was already investigating the participant's trading with respect to an earlier NG contract expiration. The Division believes that when a market participant, whether member or non-member, commits position or expiration limit violations of this magnitude, the Exchange should respond with disciplinary action and sanctions commensurate with the serious nature of the violations.<sup>51</sup> When serious position and exemption limit violations are not sanctioned, an exchange's deterrence against similar violations can be significantly weakened.<sup>52</sup>

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<sup>50</sup> The other non-member market participant with two exemption limit violations during the target period exceeded the applicable exemption limits by 127 percent on the first occasion and 132 percent on the second occasion.

<sup>51</sup> The Application Guidance for Core Principle 5, *Position Limitations or Accountability*, specifically provides that when a position or exemption limit violation is detected, an exchange "should consider appropriate action, regardless of whether the violation is by a non-member or member . . ." Commission Regulations, Appendix B to Part 38, Core Principle 5(b)(8).

<sup>52</sup> When the market participant involved exceeded the applicable position and exemption limits in natural gas for the first time during the target period, MSD issued a warning letter to the participant, but did not issue a warning letter to the participant's clearing member for the trades involved. NYMEX Rule 9.36(A) provides that a clearing member does not itself violate position limit rules by carrying a customer position that exceeds position or exemption limits unless the position exceeds the limits for two consecutive business days. NYMEX Rule 9.36(B) calls for a warning letter to both the customer and clearing member when a customer first exceeds the limits, unless the clearing member involved does not clear all accounts of the customer in question, and thus could not know that the customer's aggregate position, including accounts at other clearing firms, had exceeded the limits. At the relevant time, the participant had more than one clearing member. MSD informed the Division that, as it did in this instance, it routinely calls the clearing member involved to verify position data whenever a market participant exceeds position or exemption limits, and that this call gives the clearing member notice of the participant's limit violation. While the Division recognizes that such calls may provide de facto notification to clearing members when a market participant first violates a position or exemption limit, the Division believes that prompt and effective enforcement of the Exchange's position limit rules would be enhanced by having MSD transmit a copy [continued]

Based on the foregoing, the Division finds that the Exchange has an adequate program for monitoring positions that trigger position accountability levels, and investigating potential position and exemption limit violations. However, the Division recommends that the Exchange review its program for monitoring and sanctioning position and exemption limit violations, and make whatever adjustments are needed to ensure that position and exemption limit offenses by any market participant that involve serious and substantial violations of Exchange rules result in disciplinary proceedings and sanctions sufficient to deter such conduct by market participants.

## **F. Monitoring of EFRPs**

### **1. EFRP Transactions**

NYMEX's rules provide for several different types of EFRPs, including Exchange of Futures for Physicals ("EFP"), Exchange of Futures for Swaps ("EFS"), and Exchange of Options for Options ("EOO") transactions.<sup>53</sup> During the target period, Exchange rules also provided for Inter-Exchange Arbitrage ("IXA") transactions, although transactions of this type are now handled as block trades.<sup>54</sup> EFPs and EFSs may be effected in all futures contracts offered for either open outcry or electronic trading on the Exchange, while EOOs may only be effected in the Exchange's energy options contracts.<sup>55</sup>

An EFRP's "related position" (i.e., a physical or cash market position, a swap, or an OTC derivative) must involve the commodity underlying the futures contract, or must be a derivative,

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*[continued]* of each warning letter issued to a market participant for a first limit violation to the participant's clearing member or members.

<sup>53</sup> EFPs and EFSs are governed by NYMEX Rules 6.21 and 6.21A, respectively, while Rule 6.21F addresses EOOs.

<sup>54</sup> Rule 6.21B, Inter-Exchange Arbitrage Transactions, was deleted effective February 26, 2007, and activity previously conducted pursuant to Rule 6.21B is now handled pursuant to Rule 6.21C, Block Trades. IXAs were intended to address the processing of the NYMEX "Light Sweet" or "CL" leg of what is typically referred to as a Brent/TI transaction, privately negotiated on the basis of a stated price differential, where the "Brent leg" was executed on another exchange and the NYMEX "CL" leg was 50 contracts or larger.

<sup>55</sup> NYMEX's total EFRP volume during the target period was 152,845,288 contracts, including the following: EFPs, 4,838,068 contracts (96,882 transactions); EFSs, 104,223,334 contracts (920,324 transactions); EOOs, 41,163,218 contracts (278,942 transactions); and IXAs, 2,620,668 contracts (12,370 transactions).

by-product or related product of such commodity that has a reasonable degree of price correlation to the underlying commodity. Generally, EFRPs consist of two simultaneous transactions that are discrete but related. 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. The parties to an EFRP must report the transaction to the Exchange as soon as possible after determination of the terms of the underlying transactions, but in no event later than the next business day or the end of the posting period following expiration of the underlying futures contract, whichever is earlier. Exchange rules also require clearing members representing the buyer and seller to report each EFRP to MSD by noon of the second business day after the transaction is posted. If requested by the Exchange, the parties to an EFRP must provide documentation verifying the bona fide nature of both the futures transaction and the cash, swap or OTC transaction involved in the EFRP.

## **2. EFRPs Involved In ClearPort Clearing**

NYMEX offers clearing services for OTC energy and metals transactions through its ClearPort Clearing System (“ClearPort”).<sup>56</sup> In such transactions, the buyer and seller enter into a trade off of the Exchange, on a bilateral basis, and then post an EFS or EFP directly to ClearPort.

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<sup>56</sup> Contracts offered for clearing through ClearPort Clearing have been certified by NYMEX as designated contract market products, and they are also offered for trading on the Exchange’s ClearPort Trading System. However, the Exchange has only de minimis volume in trades executed on ClearPort Trading. Most trades in products cleared through ClearPort Clearing are executed off the exchange on a bilateral, over-the-counter basis.



The NYMEX clearing house then clears the transaction in the same manner as other Exchange contracts, thus reducing counterparty risk for the OTC transaction parties. As designated contract market contracts, EFSs and EFPs posted on ClearPort are included in the Exchange's overall volume statistics, included in position calculations relating to position accountability levels and position and exemption limits, and monitored by MSD in the same manner as other EFRPs. ClearPort participants must qualify as eligible contract participants ("ECPs"), as defined in § 1a(12) of the Act; must have an account guaranteed by a NYMEX clearing member; and must retain written confirmation and other documentation of their transactions.<sup>57</sup>

### **3. Review Of EFRPs**

MSD conducts daily review of EFRPs to ensure their compliance with NYMEX rules and verify the bona fide nature of the underlying transactions as part of its routine surveillance of market activity. The review process covers both EFRPs transacted on the Exchange and EFRPs submitted for ClearPort clearing. Analysts performing EFRP reviews are aided by a new LTRS EFRP Tracking System, developed since the 2003 Review, which cross-references customer identification information from LTRS and the StreetBook to provide a view of both the buy and sell sides of the EFRP, including identification of the traders involved by account number and

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<sup>57</sup> Pursuant to regulatory relief granted to NYMEX by the Commission under § 2(h)(1) of the Act, NYMEX also allows Exchange floor members who do not meet the usual statutory tests for ECP status with respect to financial assets to participate in transactions in certain OTC products cleared through ClearPort, if they are guaranteed by a NYMEX clearing member for that purpose and meet all requirements of NYMEX rule 6.21(G), which governs this special program. A floor member may participate in such transactions only for his or her own proprietary account, and may not be a counterparty to any other NYMEX floor member in such transactions. Floor members must notify MSD of their intended participation prior to entering into any ClearPort transaction. MSD maintains records concerning all participating floor members in its ClearPort ECP Log, and retains copies of clearing member guarantees given for this purpose in its ECP files.

name.<sup>58</sup> This tool has increased staff efficiency by eliminating the need to collate such information manually. Analysts can use the Tracking System to conduct statistical analysis, or to search and sort EFRP data by customer, trade date, clearing member, commodity, quantity, and price. This enables analysts to take a research-based approach to identifying ex-pit transactions that could involve violations of Exchange rules.

Analysts open an EFRP inquiry whenever an anomaly suggests that further examination is warranted. An inquiry may be initiated if the EFRP involves related entities as counterparties, an unusually large quantity of contracts, a trade price out of the prevailing price range for the time period in question, a party that is the subject of an ongoing investigation, an apparent non-commercial customer, or a new market participant.<sup>59</sup> Randomly selected EFRPs are also reviewed. All inquiries are tracked in MSD's EFRP inquiry log. When conducting an inquiry, an analyst requests trade confirmation statements, order tickets, and other relevant documents concerning both the futures transaction and the related transaction involved in the EFRP from both the transaction parties and the clearing members involved. The analyst then reviews the documents to verify the bona fide nature of the EFRP. As part of each review, the analyst also verifies that each non-commercial market participant involved is qualified as an ECP.<sup>60</sup> After completing the review, the analyst discusses his or her finding with the appropriate supervisor,

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<sup>58</sup> Information concerning both parties to each EFRP is also verified with the clearing members involved. MSD sends each clearing member a daily report of all EFRP transactions in which the clearing member was involved. The clearing member is required to return the report with verified information concerning its customers involved in the listed EFRPs. If an EFRP party is unknown, the analyst obtains identification of the party from the relevant clearing member, and enters the information in the LTRS database.

<sup>59</sup> When a transaction involves a new ClearPort participant, MSD contacts the clearing member involved to verify the participant's ECP status.

<sup>60</sup> If a NYMEX floor member is involved in a ClearPort EFRP transaction pursuant to Exchange Rule 6.21(G), MSD also verifies that the floor member is not violating the prohibition on floor members being counterparties to each other in ClearPort transactions. If such a violation is detected, the transaction is deemed void, and MSD notifies the involved floor members and their clearing members, enters the matter in the Rule Violation Log, and issues a warning letter or pursues disciplinary action as provided in Exchange rules.

and enters the conclusion in the EFRP log. If rule violations are found, MSD may address them through warning letters, or may open an investigation tracked in the investigation log. If an investigation reveals violations warranting disciplinary action, the matter is brought before the BCC.

During the target period, MSD conducted 209 inquiries to verify the ECP status of EFRP participants. In such inquiries, MSD staff obtain documentation from the participant's clearing member that verifies that the participant is qualified as an ECP. The Division examined a random sample of 25 ECP inquiry files and related ClearPort ECP Log entries. The files and log entries examined contained appropriate email and other correspondence between MSD and the clearing members involved, documentation of the participant's financial information and ClearPort Clearing transactions (where applicable), and certification of the participant's ECP eligibility signed by a representative of the guaranteeing clearing member.

MSD opened 163 inquiries into the bona fides of EFRPs during the target period.<sup>61</sup> As a result of 12 of these inquiries, MSD issued a total of 15 warning letters and one advisory letter.<sup>62</sup> Twelve inquiries were suspended by MSD when the Commission opened investigations into the trading involved. One hundred thirty eight inquiries were closed without action, and one inquiry remained ongoing at the close of the target period.

MSD conducted two investigations involving EFRPs during the target period, both of which had been opened prior to the target period. One investigation disclosed execution of non-

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<sup>61</sup> The EFRP inquiries included 30 involving EFPs, 102 involving EFSs, 22 involving EOOs, and nine involving IXAs. Given the 400-fold increase since the 2003 Review in the Exchange's ClearPort Clearing volume, which consists of EFRPs, the Division encourages the Exchange to reexamine its program for generating EFRP inquiries and the criteria used to select matters for inquiry, and consider whether a higher percentage of EFRPs, and particularly of EFPs, should be reviewed by MSD.

<sup>62</sup> An advisory letter reminds a market participant of Exchange rule provisions that may apply to the participant's conduct and puts the participant on notice that the Exchange views certain actions as potential rule violations. Unlike warning letters, advisory letters do not become part of the participant's disciplinary record considered by disciplinary committees in subsequent proceedings.

bona fide EFPs in unleaded gasoline by two clearing members and one non-clearing member, and resulted in issuance of warning letters to each of the firms, and a Commission enforcement action against one firm.<sup>63</sup> The other investigation, involving potential violations occurring when a market participant used EFS transactions to move positions between clearing members, was suspended by MSD when the matter became the subject of a Commission investigation.

The Division reviewed 150 of the 163 EFRP inquiries, and reviewed MSD's investigation concerning non-bona-fide EFPs in unleaded gasoline.<sup>64</sup> Inquiry files examined contained documentation appropriate for verifying the bona fide nature of the EFRPs, including trade confirmations, records of both the futures and cash sides of transactions, order tickets, bills of lading, pipeline delivery instructions, inline transfer documents, terms of payment and cash confirmations, product inspection reports, and shipping schedules. The files also contained correspondence between MSD staff and EFRP participants, and, in one instance, a copy of a warning letter issued to a clearing member firm for failure to fully comply with MSD's request for documents. The Division found that MSD's inquiries were thorough, expanded when necessary, completed in a timely manner, and adequate for purposes of verifying the bona fides of the EFRPs examined. The Division also found that the investigation into non-bona-fide EFPs was well documented, and that the file contained, among other records, investigative reports, correspondence and submitted documentation, analytical reports, case tracking logs, and copies of warning letters.<sup>65</sup>

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<sup>63</sup> This investigation had been open for over three years before its closure during the target period.

<sup>64</sup> The Division also reviewed 12 EFP inquiries and 13 EOO inquiries closed shortly after the end of the target period.

<sup>65</sup> This report does not comment on the investigation itself because the matter is currently the subject of an ongoing Commission proceeding.

## **G. Miscellaneous MSD Inquiries And Investigations**

During the target period, MSD initiated and closed seventeen inquiries related to the reporting of positions to the Exchange by clearing members. Two of these inquiries resulted in issuance of warning letters to member firms. One firm had failed to report a large position in crude futures and also had a discrepancy with its proprietary position. The other firm was found to have erroneously reported a reduction in its spot month unleaded gasoline position. The remaining 15 inquiries were closed without action.

In addition, MSD initiated and closed 23 inquiries related to a variety of potential violations, involving floor broker obligations (one inquiry), simultaneous buy and sell orders (one inquiry), reporting of metal stocks and receipts (one inquiry), pre-arranged trading (four inquiries), clearing procedures (three inquiries), final day of trading procedures (six inquiries), large trader reporting levels (two inquiries), delivery procedures (three inquiries), delivery margins and payments (one inquiry), and an EFP transacted after the trading deadline (one inquiry). The three inquiries relating to clearing procedures resulted in warning letters being issued to three clearing members for making late adjustments to their spot month heating oil positions, and the inquiry relating to floor broker obligations resulted in a warning letter for untimely posting of EFP transactions by a floor member. One inquiry relating to pre-arranged cross trades evolved into an investigation. The remaining 18 inquiries were closed without action.

MSD also conducted 11 inquiries resulting from referrals and questions received from Commission staff, which MSD tracks in a separate CFTC Cases investigation log. These inquiries involved possible untimely reporting of position adjustments by an FCM; possible discrepancies in figures included in the Exchange's Daily Market Report; and information requests from Commission staff concerning option deltas, pricing of a new natural gas index

contract, an ex-pit transfer of positions between two FCMs, customer position data for a last trading day in the NG contract, and the Exchange's transmission of data to the Commission. Three inquiries into untimely reporting of position adjustments resulted in issuance of three warning letters to the FCMs involved.

The Division reviewed the ten inquiries of all types that resulted in issuance of warning letters or evolved into investigations, and a random sample of nine of the remaining inquiries. It also reviewed the matters tracked in the CFTC Cases log. The Division found that each inquiry file was well documented, containing, among other things, correspondence between MSD and the involved parties, reports by MSD staff concerning the suspected offenses, and copies of all warning letters issued. MSD addressed Commission referrals expeditiously, and responded promptly to information requests from Commission staff.

MSD closed six investigations during the target period, including four opened prior to the target period and two opened during the target period. MSD also conducted four investigations during the target period that were opened before the period began and remained open after its conclusion. The 10 investigations focused on possible violations involving cross trading (4); natural gas trading near the close (3); crude oil trading in outer delivery months (1); wash trading (1); and erroneous position reporting by a clearing member (1). Two of the closed investigations resulted in disciplinary action. The wash trading investigation resulted in disciplinary action culminating in assessment of a total of \$80,000 in fines and a cease and desist order. The erroneous position reporting investigation resulted in issuance of a warning letter to the clearing member involved. MSD referred one closed investigation to the Exchange's trade practice compliance section for a separate investigation of possible violations of Exchange recordkeeping

rules. The three other closed investigations did not disclose wrongdoing leading to disciplinary action.

Finally, during the target period the Exchange completed disciplinary action, begun prior to the target period on the basis of an earlier MSD investigation, against a member firm, one of its employees, and a floor brokerage group's phone clerk, for prearranged trading, noncompetitive trading and withholding of orders from the market. The sanctions imposed included fines totaling \$307,000 and orders to cease and desist from further similar violations.

The Division reviewed five of the six miscellaneous investigations closed during the target period. It found that MSD conducted thorough investigations and made appropriate analyses. Investigation files were well-documented, and included order tickets and account statements, reconstructions of trading sequences, copies of relevant LTRS reports, recordings of recorded interviews, and copies of correspondence and emails.

The Division notes that, out of the total of 16 investigations of all types conducted during the target period, four investigations were open for unusually long periods of time. One investigation closed during the target period had been open for more than three years. It was suspended during part of this time on account of a Commission investigation into the same matter. Another investigation which remained open at the end of the target period and was closed in September 2007 was also open for more than three years. Two additional investigations were open for more than two years, one opened before the target period that was closed after the target period in August 2007, and one opened prior to the target period and still open at the end of March 2008. Investigations of this length can sometimes be justified, as appears to have been the case in some of these matters, by the presence of complex fact patterns, multiple document requests, multiple parties, delays created by actions of counsel, interaction

with Commission investigations, or other significant reasons that extended time is required. Staff or supervisory turnover—which was present during the target period—can also impact investigation length in practice, although it should not be allowed to have an undue effect. However, 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 can be diminished and self-regulatory effectiveness can be reduced. The Division therefore encourages the Exchange to minimize as far as possible the number of investigations remaining open for such extended periods.



## **V. CONCLUSION**

The Division finds that NYMEX maintains an adequate, effective, and comprehensive market surveillance program. Each day, MSD monitors futures and cash market prices, market news, volume, open interest, and data on available supply and demand. It also conducts daily review of the trading and positions of large traders. MSD's principal tool for monitoring trading is NYMEX's LTRS, which incorporates a number of new or upgraded electronic surveillance tools. Although MSD has experienced a modest staff increase of two positions since the 2003 Review, its size has not kept pace with the approximate tripling of volume, quadrupling of product offerings, and 400-fold increase in the volume of over-the-counter transactions cleared on ClearPort Clearing which the Exchange has experienced over the same period.

MSD heightens surveillance of expiring contracts to detect and prevent price manipulations and facilitate orderly liquidations, and maintains well documented expiration control files. MSD further expanded its scrutiny of several unleaded gasoline futures contract expirations during the phase-out of a previously-used gasoline additive due to environmental concerns. MSD took a number of steps to ensure the orderly functioning of the Exchange's gasoline futures markets, and the expirations involved unfolded without significant problems. MSD similarly expanded its scrutiny of a number of natural gas futures contract expirations, due to significant price volatility and high trading volume in the entire U.S. market for natural gas. MSD increased contacts with market participants concerning position accountability and position limits, and initiated reviews and investigations of trading. It also undertook an appropriate "lessons learned" review, and took a number of significant steps to further improve its process for handling similar situations.

MSD monitors compliance with the Exchange's position accountability, position limit, and hedge exemption rules through daily review of LTRS position reports. MSD took action on 786 exemption applications, and generally maintained well documented exemption files, but in some instances exemption applicants did not appear to have demonstrated sufficient cash or swap market exposure to justify the requested exemptions. Following appropriate procedures for assessing positions that reach position accountability levels, MSD opened 236 position accountability inquiries, responded promptly when accountability levels were reached, and took appropriate and timely action when needed. MSD opened 405 inquiries into possible position or exemption limit violations, found violations in 34 inquiries resulting in warning letters or summary sanctions, and brought disciplinary charges in two matters. The Division notes that when two market participants exceeded position or exemption limits during the spot month by more than 150 percent, the Exchange did not bring disciplinary charges, but only issued warning letters.

MSD reviews EFRP transactions daily, with the aid of new LTRS electronic surveillance tools, to ensure their compliance with NYMEX rules and verify the bona fide nature of the underlying transactions. This review includes EFRPs posted on the Exchange's ClearPort Clearing system. MSD opened 163 inquiries into the bona fides of EFRPs and 209 inquiries to verify the eligible contract participant status of EFRP participants. Inquiries and investigations were well documented, thorough, expanded when necessary, and adequate for purposes of verifying the bona fides of the examined transactions.

MSD initiated and closed 51 well documented inquiries relating to position reporting by clearing members and a variety of other potential violations, resulting in issuance of nine warning letters to eight member firms and one floor member. MSD also closed six

investigations involving possible cross trading, washing trading, trading near the close or in outer delivery months, and other potential violations. Two investigations resulted in disciplinary actions culminating in a warning letter, assessment of a total of \$80,000 in fines, and a cease and desist order. The Exchange also completed disciplinary action resulting from two earlier MSD investigations into prearranged trading, noncompetitive trading, and withholding of orders, imposed fines totaling \$307,000, and issued cease and desist orders.

Based on the foregoing, the Division makes the following recommendations for further improvements to the Exchange's market surveillance program:

- The Exchange should increase its MSD staff to a level that will keep pace with the Exchange's growth in volume and products offered and ensure the continued adequacy and efficacy of the Exchange's market surveillance program.
- The Exchange should review its procedures for granting or denying position limit exemption requests, and make adjustments as needed to ensure that all exemptions granted are based on the applicant's demonstrated cash market or swap exposure. To help ensure that this goal is met, MSD should include in all exemption files a work sheet showing how staff determined the appropriate exemption level to be granted, and should require all exemption applicants to complete an exemption application form.
- The Exchange should review its program for monitoring and sanctioning position and exemption limit violations, and make whatever adjustments are needed to ensure that position and exemption limit offenses by any market participant that involve serious and substantial violations of Exchange rules result in disciplinary proceedings and sanctions sufficient to deter similar conduct by market participants.