

**RULE ENFORCEMENT REVIEW  
OF THE  
COFFEE, SUGAR & COCOA EXCHANGE, INC.**



Division of Market Oversight  
May 27, 2004

# Table of Contents

I.	INTRODUCTION .....	1
II.	SUMMARY OF FINDINGS AND RECOMMENDATIONS.....	4
	A. Audit Trail Program.....	4
	B. Trade Practice Surveillance Program.....	4
	C. Disciplinary Program.....	5
	D. Dispute Resolution Program.....	6
III.	AUDIT TRAIL PROGRAM .....	7
	A. Order and Trade Flow.....	8
	B. Trade Timing .....	10
	C. Audit Trail Reviews.....	10
	D. Safe Storage Capability.....	13
	E. Conclusions and Recommendations .....	13
IV.	TRADE PRACTICE SURVEILLANCE PROGRAM.....	14
	A. Staffing.....	15
	B. Computerized Surveillance.....	16
	C. Floor Surveillance.....	18
	D. Investigations .....	20
	1. Types and Sources of Investigations.....	20
	2. Adequacy of Investigations.....	21
	3. Cross Trade Investigations.....	25
	E. Conclusions and Recommendations .....	30
V.	DISCIPLINARY PROGRAM.....	32
	A. Disciplinary Committees and Procedures.....	32
	B. Adequacy of Sanctions .....	36
	C. Conclusions and Recommendations .....	38
VI.	DISPUTE RESOLUTION PROGRAM.....	39
	A. Customer Arbitration .....	39
	B. Member-to-Member Arbitration.....	41
	C. Arbitrations During the Target Period .....	42
	D. Conclusions and Recommendations .....	42

**RULE ENFORCEMENT REVIEW  
OF THE  
COFFEE, SUGAR & COCOA EXCHANGE, INC.**

**I. INTRODUCTION**

The Division of Market Oversight (“Division”) has completed a rule enforcement review of the trade practice surveillance, audit trail, disciplinary, and dispute resolution programs of the New York Board of Trade’s Coffee, Sugar & Cocoa Exchange, Inc. Division (“CSCE” or “Exchange”) for compliance with related core principles under Section 5(d) of the Commodity Exchange Act (“Act”) and Part 38 of the Commission’s regulations.<sup>1</sup> The review covers the period of June 1, 2002 through June 1, 2003 (“target period”).<sup>2</sup>

Specifically, the Division evaluated Exchange compliance with five core principles. Core Principle 10– Trade Information and Core Principle 17- Recordkeeping, relate to the maintenance of an audit trail that can be used to assist a contract market in the identification and

---

<sup>1</sup>The New York Cotton Exchange (“NYCE”) and its subsidiaries, the New York Futures Exchange, the Financial Instruments Exchange, and the Citrus Associates of NYCE, merged with CSCE in June 1998 to form the New York Board of Trade (“NYBOT”). NYBOT is composed of two subsidiaries, CSCE and NYCE and its subsidiary exchanges. This review addresses only CSCE’s compliance programs and investigations. As of June 10, 2004, there will be no division between CSCE and NYCE and its subsidiary exchanges. NYBOT will be the designated contract market for all of its exchanges.

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 analysis, 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. The 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.

<sup>2</sup> NYBOT’s facilities in Four World Trade Center were completely destroyed in the September 11, 2001 terrorist attacks. NYBOT’s exchanges traded from its Long Island City back-up facility on abbreviated schedules from September 17, 2001 through August 2003, which includes the entire target period. Due to space limitations, NYBOT’s Compliance Department staff rotated between temporary Manhattan offices and the Long Island City trading facility. On September 2, 2003, all of NYBOT’s exchanges began trading from their new space in the New York Mercantile Exchange building.

prosecution of customer and market abuses and the maintenance of trade-related records; Core Principle 2- Compliance with Rules and Core Principle 12- Protection of Market Participants, relate to surveillance, enforcement, and disciplinary procedures used by a contract market to protect market participants from abusive trading practices; and Core Principle 13- Dispute Resolution, relates to fair and equitable dispute resolution procedures for customers and member-to-member disputes.<sup>3</sup>

To assess the Exchange's compliance with these core principles, Division staff reviewed numerous documents used by NYBOT's Compliance Department in performing its routine self-regulatory responsibilities. These documents included, among others, Compliance Department manuals and guidelines;<sup>4</sup> computer reports and other documentation used routinely for audit trail enforcement and trade practice surveillance; audit trail recordkeeping review files; trade practice investigation and disciplinary action files; floor surveillance, trade practice investigation, and disciplinary case logs; and minutes of disciplinary committee and Board of Director meetings held during the target period. The Division also interviewed officials from NYBOT's Market Regulation Unit, including the Senior Vice President, Market Regulation; the Vice President, Compliance; and the Manager, Special Investigations with respect to the operation of the Exchange's self-regulatory programs.<sup>5</sup>

---

<sup>3</sup> Appendix B to Part 38 of the Commission's regulations provides guidance concerning the core principles with which a designated contract market must comply to maintain its designation. In addition, Appendix B provides acceptable practices for several of the core principles. Although the acceptable practices establish non-exclusive safe harbors, they do not establish a mandatory means of compliance with the core principles. Appendix B provides acceptable practices for Core Principles 2, 10, 13, and 17. However, acceptable practices are not set forth for Core Principle 12. In promulgating Part 38, the Commission reserved the authority to adopt acceptable practices for Core Principle 12 at a later date.

<sup>4</sup> A copy of NYBOT's *Handbook for Staff of the Compliance Department* ("Compliance Manual") can be found in Appendix 1.

<sup>5</sup> A copy of the July 25, 2003 interview transcript can be found in Appendix 2. Cites to the transcript are hereinafter referenced as "Transcript, p. \_\_\_\_."

The Division provided the Exchange an opportunity to review and comment on a draft of this report on April 30, 2004. On May 18, 2004, Division staff conducted an exit conference with NYBOT officials to discuss the report's findings and recommendations.

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

### **A. Audit Trail Program**

#### **Findings**

- The Exchange maintains an adequate audit trail program that provides for the recording and safe storage of trade information in a manner that allows staff to use the information to assist in the prevention of customer and market abuses and to provide evidence of rule violations.
- One-minute trade times are imputed algorithmically by CSCE's automated audit trail system using time and sequence data entered by both buyers and sellers.
- The Exchange conducts an annual audit trail review of each market for compliance with Exchange order ticket and trading card requirements. In this regard, the Division found that members demonstrated a high level of compliance with Exchange audit trail rules.

**The Division has no recommendations in this area.**

### **B. Trade Practice Surveillance Program**

#### **Findings**

- The Exchange generally maintains an adequate trade practice surveillance program. However, the Division identified one aspect of that program, the Exchange's procedures for monitoring compliance with its cross trade rules, that should be enhanced.
- Potential trade practice violations typically are identified through the use of computerized surveillance and floor surveillance. The Exchange opened 80 and closed 111 trade practice investigations during the target period, the vast majority of which were generated internally. The Division found that investigations were thorough, well documented and completed in a timely manner.
- The Exchange has improved its investigation procedures by expanding the scope of investigations to include a subject member's trading over a period of time sufficient to identify a pattern of violations, examining all of a subject member's trading cards and order tickets for the entire day that suspect trades occurred, and including a calculation of members' profits and losses and customer losses in investigation reports.

- The Exchange manually reviews lengthy monthly cross trade reports to identify suspicious cross trades, a process that can be enhanced by the use of exception reports. The Exchange completed 15 cross trade investigations during the target period, only two of which involved large-size cross trades. The Division identified numerous other large-size cross trades that it believes should have been investigated based on the size of the trades to ensure that they did not involve noncompetitive trading. Large-size cross trades are one of the Exchange's criteria for further investigation.
- The Division also identified numerous small-size cross trades executed by a small number of brokers in liquid months that it believes should have been examined. Given that small-size orders offered to the market in liquid contracts typically should be able to be filled without a broker crossing orders, brokers who execute a significantly large number of small size cross trades should be subject to further review. Under current Exchange procedures, these cross trades are not subject to routine review.
- The Exchange's Floor Surveillance Log reflected few entries for its option markets. Therefore, the Division was unable to determine if adequate floor surveillance was conducted for those markets.

### **Recommendations**

- **The Exchange should increase the number of large-size cross trades it investigates and develop procedures to examine brokers who execute a large number of small-size cross trades in liquid contract months. In addition, the Exchange should develop an automated exception report that identifies cross trades that meet the Exchange's criteria for further review.**
- **The Exchange should document floor surveillance conducted for its option markets.**

### **C. Disciplinary Program**

#### **Findings**

- The Exchange maintains adequate disciplinary procedures. During the target period, nine cases were referred by staff for disciplinary action. All of the cases were resolved in a timely manner pursuant to settlement agreements.
- The Exchange levied fines totaling \$143,500 against nine members and ordered customer restitution totaling \$23,150. This included a \$125,250 fine against one member for various trade practice violations, which is the largest fine in Exchange history. That fine was coupled with other sanctions including a 13- month suspension and a lifetime ban on executing customer orders.

- The Division found two similar trading ahead cases that resulted in significantly disparate monetary sanctions, one of which the Division believes was insufficient given the seriousness of the violation.

### **Recommendations**

- **The Exchange should impose consistently meaningful sanctions in similar cases involving substantive trading abuses.**

## **D. Dispute Resolution Program**

### **Findings**

- The Exchange's arbitration rules provide for fair and equitable procedures for the resolution of customer and member disputes. Customers have the opportunity to have their claims heard by disinterested panels, including panels where a majority of the panelists are not members or associated with any member of a contract market, or otherwise associated with a contract market.
- Each party has the right to counsel and each party receives adequate notice of claims presented against them and an opportunity to be heard on all claims, defenses, and counterclaims. The Exchange's arbitration procedures require a prompt hearing and authorize prompt and written awards by panels with authority to issue awards or any remedy or relief it deems just and equitable.
- Adequate procedures also are provided for mandatory member-member arbitration, and for disciplinary action to enforce panel decisions. Member-member arbitration is separate from and independent of customer claims submitted for resolution and does not interfere with or delay customer disputes.
- The two disputes decided during the target period, which included one customer-member arbitration and one member-member arbitration, were resolved in accordance with Exchange rules and procedures.

**The Division has no recommendations in this area.**



### III. AUDIT TRAIL PROGRAM

#### **Core Principle 10 – Trade Information:**

**The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables the contract market to use the information for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market.**

#### **Core Principle 17 – Recordkeeping:**

**The board of trade shall maintain records of all activities related to the business of the contract market in a form and manner acceptable to the Commission for a period of five years.**

Pursuant to the acceptable practices set forth in Appendix B to Part 38 of the Commission's regulations, an effective contract market audit trail should capture and retain sufficient trade-related information to permit contract market staff to detect trading abuses and reconstruct transactions within a reasonable period of time. In addition, the contract market must create and maintain an electronic transaction history database that contains information with respect to transactions executed on the designated contract market. An acceptable audit trail also must be able to track a customer order from time of receipt through fill allocation or other disposition. Further, an acceptable audit trail should include original source documents, transaction history, electronic analysis capability and safe storage capability.

Original source documents include unalterable, sequentially identified records on which trade execution information is originally recorded, whether recorded manually or electronically. A transaction history consists of an electronic history of each transaction, including all data that are input into the trade entry or matching system for the transaction to match and clear. These data should include the categories of participants for whom such trades are executed; timing and sequencing data adequate to reconstruct trading; and the identification of each account to which fills are allocated. An electronic analysis capability permits sorting and presenting data included

in the transaction history so as to reconstruct trading and to identify possible trading violations, while safe storage capability provides for a method of storing the data included in the transaction history in a manner that protects the data from unauthorized alteration, accidental erasure or other loss.

Commission Regulation 1.31 governs the manner in which an exchange is required to maintain trade-related records. The regulation mandates that all records required to be kept under the Act or Commission regulations be maintained for five years and be readily accessible during the first two years. Most categories of required records may be stored on either micrographic or electronic storage media for the full five-year maintenance period. However, trading cards, documents on which trade information is originally recorded in writing, and order tickets must be retained in hard copy for five years.

#### **A. Order and Trade Flow**

The Exchange requires that FCMs and introducing brokers receiving customer orders immediately prepare an order ticket upon receipt that includes account identification, order number, a timestamp indicating when the order was received, and for option orders, a timestamp indicating the time the order is transmitted for execution. Similarly, members receiving customer orders on the Exchange floor must immediately prepare a floor order ticket upon receipt that includes account identification, order number, an entry timestamp indicating when the order was received on the floor, and an exit timestamp indicating the time that report of execution was made from the floor.<sup>6</sup>

---

<sup>6</sup> In March 2002, NYBOT deployed its Electronic Order Routing system (“EOR”). EOR, along with the Order Book Management System (“OBMS”), allows users to send orders via the Internet directly to a booth on the trading floor, where the orders are run into the pit and executed via open outcry. Upon receiving the fill, the broker’s clerk sends back a fill confirmation through the system. EOR/OBMS also allows users to check their order status and to access

The Exchange also requires each member to promptly record all trade executions (for personal and customer accounts) on single-sided sequentially numbered trading cards provided by the Exchange. Trades must be recorded in non-erasable ink, in chronological order, and without skipping lines between trades. In addition, a separate trading card must be used for each bracket period, including the open, close, and post-close trading periods. Further, erroneous information must be crossed out by a single line and not be obliterated or otherwise made illegible.

Members must record the following information on each trading card: the member's name or symbol, the name or symbol of the opposite broker; the bracket period; date; execution time for the first trade on the card; quantity, month and price for each transaction; and for option contracts, premium, strike price, and put or call indicator. In addition, cross trades must be clearly identified along with the time of execution. Trading cards must be submitted to designated Exchange employees within 15-minutes of the end of each bracket period, and if any lines remain after the last trade recorded on a card before submission, the remaining lines must be crossed through.

Floor members are responsible for ensuring that trade information for clearing purposes is input into TIPS. Trade data typically are input by members' clerks. The Exchange requires that trades be input into TIPS no later than 30 minutes after the end of the bracket period in which they are executed.<sup>7</sup> Late submission of a member's trade data results in a summary fine of

---

timely market data from the Exchange's price reporting system. Two broker groups are currently using EOR/OBMS on the CSCE. NYBOT recently reported that its divisions are averaging a total of approximately 2,000 EOR orders per week. NYBOT also has launched an Automated Trading Card ("ATC"). The ATC allows locals to electronically enter trades on a wireless hand-held unit. The trades are then matched and cleared almost instantaneously through the Exchange's Trade Input Processing System ("TIPS"). (See p. 10 for further discussion of TIPS.) Two CSCE locals currently use an ATC device, one in the sugar pit and the other in the coffee pit.

<sup>7</sup> CSCE Resolution 5, Trade Data Input Procedures, attached as Appendix 3.

\$100 for the first occurrence, \$500 for a second occurrence within a 12-month period, \$1,000 for a third occurrence within a 12-month period, and referral to the BCC for a fourth occurrence.<sup>8</sup>

## **B. Trade Timing**

CSCE's Audit Trail System ("ATS") is a multi-stage, automated trade time reconstruction process which uses time and sequencing data entered by both buyers and sellers, including trading card and line sequence numbers, execution times required to be manually recorded, time and sales data,<sup>9</sup> 30-minute bracket codes, and TIPS data to impute a time of execution to the minute. Based on these data, ATS determines various time spans or "windows" within which one side of each trade may have been executed. ATS then uses a series of algorithmic trade data comparisons that matches both sides of a trade, further narrows time windows, and ultimately assigns a one-minute execution time for each trade.

ATS processing, along with time and sales data and floor order timestamps to the second, allows Compliance Department staff to reconstruct the sequence of trading for investigation and evidentiary purposes. The imputed times are also integrated into the Exchange's automated surveillance system that is used to identify potential trading abuses, as discussed below.

## **C. Audit Trail Reviews**

The Exchange conducts random reviews of floor order tickets and trading cards ("audit trail reviews") in order to enforce its trade recordation requirements. Typically, Compliance Department staff conducts an annual audit trail review of each trading ring. After selecting a day for review, staff requests all trading cards and floor order tickets prepared for both futures and

---

<sup>8</sup> CSCE Rule 26.25.

<sup>9</sup> The Exchange endeavors to capture each transaction, rather than each price change, as a time and sales print.

option markets.<sup>10</sup> If a floor member who is normally an active participant in the selected market is not present for the selected date, staff will select another trade date to review that member. The documents are examined for compliance with all of the Exchange's trading card and order ticket requirements. Investigators use a spreadsheet checklist to ensure that all pertinent information is reviewed.<sup>11</sup>

The Exchange uses a pass/fail system based on all transactions examined to determine members' recordkeeping compliance, with an overall rate of 85 percent or higher considered a passing mark. However, a single instance of failing to include an account identifier on an order ticket will result in automatic failure.<sup>12</sup> Once an audit trail review is completed, each member whose trading documents were reviewed receives a letter notifying him or her of any identified violations. If a member failed the audit trail review, a warning letter is issued or the member is referred for disciplinary action, depending upon the member's past history.<sup>13</sup> Additionally, a follow-up recordkeeping review is scheduled shortly thereafter.<sup>14</sup> Similarly, the Exchange schedules follow-up recordkeeping reviews for members who fail recordkeeping reviews conducted in connection with trade practice investigations.<sup>15</sup>

---

<sup>10</sup> As explained in Section IV.D.2., p.23, investigators also review members' trading cards and order tickets during trade practice investigations.

<sup>11</sup> A copy of NYBOT's Trading Card and Order Ticket spreadsheet is attached in Appendix 4.

<sup>12</sup> Transcript, pp. 22 and 26.

<sup>13</sup> Because all Exchange records were lost in the September 11, 2001 terrorist attacks, all members began with a clean audit trail record when trading resumed the following week.

<sup>14</sup> Generally, a member will receive a warning letter for a first offense. If the member receives a failing mark on the Exchange's follow-up review, the member will be referred to the BCC. On February 11, 2004, the Exchange's Board of Managers amended CSCE Rule 26.02 to impose a summary fining system for routine recordkeeping violations. Under this rule, the Compliance Department may fine a member up to \$1,000 per recordkeeping violation if a warning letter for the same violation previously has been issued to the member in connection with another investigation, including an audit trail review.

<sup>15</sup> For example, in Investigation 2002-067, the Exchange examined a member's order tickets as part of a trading ahead investigation. Although no trading ahead violations were found, the Exchange identified several order ticket violations. The member was issued a warning letter and advised that the Compliance Department would conduct a

During the target period, the Exchange completed four audit trail reviews, examining a total of 2,732 order tickets and 2,306 trading cards prepared by 321 floor members. These reviews resulted in 59 warning letters and one BCC referral.<sup>16</sup> The Division found that the Exchange's audit trail reviews were thorough, well documented, and completed in an expeditious manner. Audit trail review files included copies of original order tickets and trading cards examined during the respective review, worksheets, spreadsheets, and copies of all resulting warning letters. Each audit trail review file also contained a form that showed the start and completion date for the review, the final report date, and the dates of any resulting disciplinary actions.

The audit trail reviews conducted during the target period revealed a high level of compliance with the Exchange's order ticket and trading card recordkeeping requirements. For example, the Exchange's audit trail review for sugar futures and option (Investigation 2002-144) examined 1,070 order tickets prepared by 52 brokers and 858 trading cards prepared by floor members. The Exchange found that all of the order tickets contained order numbers and that all but two contained account identifiers. In addition, 980 order tickets (91 percent) included both entry and exit timestamps.

With respect to trading cards, the Exchange found that all of the 858 trading cards were recorded in non-eraseable ink and that all of the trades were recorded in chronological order within the lines. In addition, 99 percent of the trading cards examined had no skipped lines, were used in sequential order, separately designated the open and close, and included the date,

---

follow-up review in the near future. The Compliance Department opened Investigation 2002-132 as its follow-up review two months later and once again found order ticket violations. The member was referred to the BCC and subsequently fined \$500.

<sup>16</sup> The member referred to the BCC was fined \$250 for trading card deficiencies. Investigation 2002-146.

quantity, and trade price. Ninety-eight percent of the cards included the executing and opposite broker, commodity, and the execution time for cross trades; 96 percent included the contract month; 92 percent included the execution time for the first trade recorded; 91 percent included bracket codes; and unused lines were crossed out on 97 percent of the trading cards.

**D. Safe Storage Capability**

NYBOT trade data and historical files are backed-up real time throughout each trading day and on mainframe/servers and tape at NYBOT's 39 Broadway site and at its Long Island City disaster recovery site. In addition, NYBOT utilizes another off-site back-up facility in upstate New York for storage and retention of tapes. All data is stored in a manner that protects the data from unauthorized alterations, accidental erasure, or other loss. In compliance with Commission Regulation 1.31, the Exchange retains trade information for five years.

**E. Conclusions and Recommendations**

The Division found that the Exchange maintains an adequate audit trail program that allows the Exchange to assign one-minute trade times and reconstruct trading. Pursuant to Core Principle 10, the Exchange maintains rules and procedures that provide for the recording and safe storage of trade data, time and sales data, and historical transactions in a manner that enables the Compliance Department to use the information to assist in the prevention of customer and market abuses and to provide evidence of any rule violation. The Exchange's program for enforcing its audit trail rules allows staff to reconstruct the path of a customer order from the time of receipt to fill allocation or other disposition. In addition, the Exchange retains audit trail data for five years in compliance with Core Principle 17.

The Exchange's audit trail enforcement program includes an annual review of each market, futures and option, for compliance with Exchange order ticket and trading card requirements. The Division found that the Exchange's audit trail reviews were thorough, well documented, and completed in a timely manner. The Division also found that members generally have a high level of compliance with the Exchange's audit trail rules and that offenders are subject to follow-up reviews. If a member is issued a warning letter and is found to have committed similar violations during the next review, the member is referred for disciplinary action.

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

#### **IV. TRADE PRACTICE SURVEILLANCE PROGRAM**

##### **Core Principle 2 – Compliance with Rules:**

**The board of trade shall monitor and enforce compliance with rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.**

##### **Core Principle 12 – Protection of Market Participants:**

**The board of trade shall establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants.**

Pursuant to Appendix B to Part 38 of the Commission's regulations, a contract market's trade practice surveillance program should have the arrangements, resources, and authority necessary to perform effective rule enforcement. The arrangements and resources attendant to the program should facilitate the direct supervision of the contract market, including analysis of relevant data. An acceptable program should have systems that maintain all data reflecting the details of each transaction executed on the contract market. In this regard, the program should include routine electronic analysis of these data to detect potential trading violations. The



program also should provide for appropriate and thorough investigation of all potential trading violations brought to the contract market's attention, including member and Commission referrals and customer complaints. In addition, the program should have the authority to discipline, suspend, or terminate the activities of members or market participants pursuant to clear and fair standards.<sup>17</sup>

#### **A. Staffing**

CSCE's trade practice surveillance is performed by NYBOT's Market Regulation Unit, which also conducts surveillance for NYCE and its subsidiary exchanges. The Market Regulation Unit, which is overseen by the Senior Vice President for Market Regulation, includes the Compliance Department, Market Surveillance Unit, and Market Statistics Unit.<sup>18</sup>

NYBOT's 16-person Compliance Department is led by an experienced and knowledgeable management team. The department is headed by the Vice President, Compliance, who is assisted by an Assistant Vice President and a Manager of Special Investigations.<sup>19</sup> The Vice President reports to the Senior Vice President for Market Regulation.

---

<sup>17</sup> That aspect of Core Principle 2 that relates to the disciplining of members who violate Exchange rules is discussed below in Section V. This section of the report addresses the Exchange's program for monitoring its markets for possible trading abuses and the investigation of any identified abuses.

<sup>18</sup> The Senior Vice President for Market Regulation, who began his current position in June 2000, has 34 years of experience in futures regulation and compliance, including 15 years at the Commodity Exchange, Inc., and a number of years on the staff of the Commission.

<sup>19</sup> The Vice President, Compliance, has over 20 years of regulatory experience, including 16 years as Vice President of Market Surveillance at NYCE. The Assistant Vice President, Compliance, has over 20 years of regulatory and compliance experience. The Manager, Special Investigations, has over 30 years of regulatory and compliance experience, including several years as Trade Practice Manager at the New York Mercantile Exchange and over 20 years on the staff of the Commission.

The Compliance Department also includes four Investigations Managers, five Senior Investigators, three investigators and one Administrative Coordinator.<sup>20</sup>

The Department's investigators are organized into four teams. Each team is led by an Investigations Manager and includes a Senior Investigator and one or two investigators. Although each team is assigned specific NYBOT markets to monitor, when necessary, teams are temporarily restructured to focus staff on markets that require additional support in response to an increase in trading activity or to perform special investigations or projects. In addition to these teams, the Manager of Special Investigations and an investigator assigned to him investigate unusual market events and potential rule violations of a serious nature on NYBOT's exchanges. The Compliance Department also has a Compliance Attorney, who is responsible for overseeing the legal aspects of all trade practice investigations and coordinating all phases of NYBOT's disciplinary proceedings.<sup>21</sup>

The Exchange appears to have adequate staffing levels to monitor its markets.

## **B. Computerized Surveillance**

The Compliance Department uses computerized surveillance as a means of detecting and investigating potential trade practice abuses. Prior to September 11, 2001, the Exchange's computerized surveillance system, the Compliance Analysis Review System ("CARS II"), served as the Exchange's primary means of detecting and investigating trade practice abuses. The Exchange's current computerized surveillance was designed to replace CARS II with three integrated component parts consisting of Daily Exception Reports ("DER"), Structured Queries

---

<sup>20</sup> A copy of the organizational chart for NYBOT's Compliance Department and position descriptions can be found in Appendix 5.

<sup>21</sup> The Compliance Attorney has been with NYBOT since September 2000. Prior to joining NYBOT's staff, the Compliance Attorney had ten years of trial experience as an Assistant District Attorney in Manhattan and Brooklyn.

Language (“SQL”), and Desktop Applications.<sup>22</sup> The current technology, referred to as a manifold computerized system, has become an integral part of the Exchange’s surveillance program to detect and investigate potential rule violations and aberrant trade practices. Each of the three components of the system is discussed below.

The DER component of the system consists of daily exception reports that are reviewed by staff on a regular basis, using predefined parameters. The reports are received on trade date plus one (“T+1”), are stored on a file server, and are available for a minimum of five years. DER’s reflect, among other things, possible instances of trading ahead of customers by floor brokers, trading ahead of customers by broker association members, unallocated trades, trades that may have been “floated” at an incorrect clearing member, and mechanical adjustments for quantity or price.

The second component, SQL, is used to identify potential trading violations and to develop and support ongoing investigations. SQL is an application that displays audit trail, time and sales, and clearing data that have been captured in various Exchange systems.<sup>23</sup> These data form the basis of ad hoc reports that investigators can further filter and sort. Distinct SQLs have been developed for, among other things, accommodation trading, direct and indirect trading against customer orders, and various types of potential trading ahead violations.<sup>24</sup> Investigators also can query SQL to display trades that resulted in no profit or loss to examine potential wash trading violations. SQL also is an important tool for investigative purposes. For example, an investigator can design a report to display all trading between two brokers for a selected date. To

---

<sup>22</sup> Representative copies of DER, SQL, and Desktop Application reports can be found in Appendix 6.

<sup>23</sup> These systems include TIPS, ATS, the Price Quote Reporting system, the Daily Market Report, and clearing data from the New York Clearing Corporation.

<sup>24</sup> Unlike DER exception reports, parameters for SQL reports can be modified.

further narrow the focus of the report, the investigator can then filter the data to view only those trades executed during a chosen period, or sort the trades involved by desired parameters, such as price or time.

The third component of the system is Desktop Applications. Desktop Applications is used for administrative and procedural functions, such as case tracking and record analysis. For example, once an investigator enters order ticket or trading card information into a worksheet template, the application completes the analysis to determine member compliance with Exchange recordkeeping rules.

Compliance Department staff typically review various exception reports and other computerized surveillance reports on a daily or weekly basis, depending on the workload of managers and their staffs. However, some activity, such as cross trades, are reviewed on a monthly basis. If the identified activity that is initially reviewed merits further investigation, a case number is assigned and an investigation is opened.

### **C. Floor Surveillance**

The Exchange also conducts floor surveillance to detect potential trading violations and deter members from violating Exchange rules. In addition, staff uses floor surveillance to observe the physical location of floor members in relation to other floor members, document various floor trading practices, and identify trading patterns that are unusual for particular members. Floor surveillance also provides the floor population an opportunity to interact with Compliance Department staff and, when necessary, to seek clarification of Exchange rules. If

Compliance Department staff has reason to believe that a member is engaging in prohibited trading activity, staff closely monitors the member's trading activity while on the floor.<sup>25</sup>

During the target period, the Exchange opened one investigation from floor surveillance. The investigation was opened after staff observed a particularly high level of activity in the sugar ring. Soon thereafter, staff was advised that the activity was related to customer accounts at a particular firm, that it was common knowledge that the trading related to the account of a fund, and that market participants were aware of the fund's large orders entering the market. Upon investigation, staff concluded that the orders were properly filled and that the floor brokers reviewed did not disclose their orders.<sup>26</sup>

All Compliance Department managers and staff are responsible for conducting floor surveillance and spend a substantial amount of time observing trading. During the period that the Exchange was trading from NYBOT's Long Island City back-up facility, it was NYBOT's practice to have Compliance Department staff present on the trading floor during the entire trading day.<sup>27</sup> Now that the Exchange is in its permanent facility at the NYMEX building, Compliance Department staff conducts floor surveillance on the open and close, at random times during the day, and when special conditions warrant. During volatile markets, there is often more than one Compliance Department staff member in the ring observing trading.

---

<sup>25</sup> Transcript, pp. 35-36.

<sup>26</sup> Investigation 2002-072. During the target period, the Exchange also closed Investigation 2002-015, which was initiated from floor surveillance prior to the target period. The Compliance Department reviewed two weeks of trading for the subject broker and found possible pre-arranged trading. The broker was issued a Compliance Department warning letter for audit trail violations and a BCC warning letter for possible violation of CSCE Rule 1.29(e), engaging in conduct or practices inconsistent with just and equitable principles of trade.

<sup>27</sup> Typically, three investigators and a Manager were on site in Long Island City. Transcript, p. 35. Division staff normally conducts daily floor surveillance at random times at all exchanges. However, because of the distance between the Commission's New York office and NYBOT's Long Island City facility, Division staff rotated spending entire days in Long Island City. Division staff consistently observed Compliance Department managers and staff, as well as NYBOT senior executive officers, on the trading floor throughout the day.

Investigators record their floor surveillance activity in a Floor Surveillance Log.<sup>28</sup> If any unusual activity occurs, staff logs the information and notifies senior staff. If senior staff agrees that the activity observed was a potential violation, an investigation is opened.<sup>29</sup> Consistent with Division staff's visual observations during the target period, the Exchange's Floor Surveillance Log included entries to reflect daily floor surveillance of coffee, cocoa, and sugar futures trading. However, similar entries were not made for the respective option markets. Although Division staff witnessed NYBOT staff and officers on the trading floor daily conducting floor surveillance, the Floor Surveillance Log provides details concerning the observed markets and provides the Division with an opportunity to review any notations regarding any observations or particular trades. Because the Floor Surveillance Log reflected few entries for the option markets, the Division is unable to determine if adequate floor surveillance was conducted for those markets.

## **D. Investigations**

### **1. Types and Sources of Investigations**

During the target period, the Exchange opened 80 investigations, including 70 that were internally-generated, eight customer complaints, and two member complaints. Of the 70 internally-generated investigations, 56 were initiated through routine review of computerized reports, one was generated from floor surveillance, 11 were generated from order ticket and

---

<sup>28</sup> A copy of the Exchange's Floor Surveillance Log can be found in Appendix 7. Log entries typically include the names of staff members conducting surveillance, the date, the time surveillance began and ended, the market observed, and noteworthy observations.

<sup>29</sup> Unusual activity or violations may include an abrupt or unusual price movement; possible disclosing, withholding, or withdrawing of orders; not trading by open outcry; excessive trading between members; unusual locations or changes in location between members; use of special signals to indicate previously agreed upon action; and any apparently purposeful bids or offers which do not reflect the state of the market, or transactions which are not in line with the prevailing market. *See* Compliance Manual, pp. 11-12, Appendix 1.

trading card reviews, and two were initiated from referrals to the Compliance Department from other Exchange departments. The potential violations examined included, among other things, trading ahead of and trading against customer orders, wash trading, accommodation trading, misuse of error accounts, and improper cross trades.

## **2. Adequacy of Investigations**

To evaluate the adequacy of the Exchange's investigations, the Division examined all 111 investigations closed during the target period, including 38 investigations that were opened prior to the target period and 73 that were opened during the target period. The Division found that the Exchange's investigations were thorough, well documented, and completed in a timely manner.

Upon initiation of an investigation, an investigator requests information from the member(s) involved by sending the appropriate form letter.<sup>30</sup> The Division observed that requests for original trading records are ordinarily sent promptly after an investigation is opened. With respect to documentation, investigation files typically included copies of daily and monthly account statements, order tickets, trading cards, time and sales data, Daily Broker Recap reports, correspondence, computerized reports, trade reconstruction worksheets, and interview notes and transcripts.<sup>31</sup>

At the conclusion of each investigation, Compliance staff prepares an investigation report describing the source, nature, and findings of the investigation and stating either staff's

---

<sup>30</sup> See Appendix 8 for copies of representative form letters used by the Compliance Department in connection with its investigations.

<sup>31</sup> Generally, interviews are taped. However, sometimes in the preliminary stages of an initial inquiry, staff may not tape interviews. When an interview is taped, the tape is retained in a sealed envelope in the respective investigation file. Tapes are only transcribed if requested by senior Compliance Department staff. *See* Compliance Manual, p. 7, Appendix 1.

recommendation for further action or reasons for closing the investigation.<sup>32</sup> The Division found that investigation reports presented material facts in a clear and concise manner and that material facts were supported by reference to a relevant document, spreadsheet, or exhibit. In addition, investigation reports contained trade reconstructions to support investigators' findings, and appropriate analyses supporting staff conclusions and recommendations. All investigation reports were reviewed, dated and signed by the Senior Vice President, who is responsible for making the final decision as to whether an investigation should be closed with no further action or with a warning letter, whether more documentation and analyses are necessary, or whether the matter should be referred for disciplinary action.<sup>33</sup>

The Division also found that in response to recommendations made in the Division's prior rule enforcement review of CSCE's trade practice programs in October 1999 ("1999 Review"), the Exchange has enhanced its investigation procedures in several respects. First, the Exchange has expanded the scope of its investigations by examining all of a subject member's original trading records for the entire day(s) that suspect trades occurred, not just the brackets of suspect trades. In this regard, original trading records are reviewed not only to determine whether there is evidence of a substantive trading violation but also for recordkeeping violations. Second, rather than focusing on examining just the "hits" generated by computerized surveillance, investigators routinely expand their inquiries to include a subject member's trading over a period of time to establish a pattern of trading violations.<sup>34</sup> Similarly, if evidence of

---

<sup>32</sup> Investigations that are closed without further action contain a brief "close-out" memorandum that explains the basis for the investigation and includes a brief summary, recommendation, and conclusion.

<sup>33</sup> Transcript, p. 95.

<sup>34</sup> Typically, an investigator will review at least one month (forward and/or backwards) of trading activity in order to determine whether a potential violation is an isolated instance or part of a larger pattern. Transcript, pp. 94-95. The Division identified several investigations that were expanded to review members' trading over extended time periods. For example, four of the ten closed non-competitive trading investigations reviewed by the Division were



trading violations are uncovered that differ from those violations that were the original subject of an investigation, the investigation is expanded to focus on all potential violations. Third, investigation reports commonly include calculation of members' profits and losses and customer losses for restitution purposes.

The Division believes that these new procedures have resulted in more thorough and expansive investigations. Several of the Exchange's investigations were complex in nature, and involved analysis of substantial amounts of data covering extended time periods. For example, Investigation 2002-135 was initiated from a routine trading card review in coffee after Compliance Department staff identified an instance where two brokers may have engaged in non-competitive trading. In reviewing one of the subject broker's trading cards, staff identified a change in quantity opposite another broker. Staff then expanded the investigation to include the third broker and reconstructed and analyzed the brokers' trading cards to determine if any violations occurred. After reviewing relevant trading documents and interviewing the brokers, the Exchange concluded that there was insufficient evidence to demonstrate non-competitive trading, and that there was no monetary benefit to either broker as a result of the quantity change. One of the brokers was issued a warning letter for trading card violations.

Investigation 2001-212 is an example of an investigation that was expanded to include examination of a potential trading violation other than the violation that was the original subject of the investigation. The investigation also was expanded to examine six months of trading. Specifically, the investigation was initially opened to examine a possible trading ahead violation. Although the investigator concluded that the subject broker did not trade ahead of his customers'

---

expanded to include review periods ranging from five to 11 months. Investigations 2001-208 and 2001-218 reviewed five months of trading activity, Investigation 2002-094 reviewed nine months of trading activity, and Investigation 2001-203 reviewed 11 months of trading activity.

orders, the investigator identified a potential accommodation trade between the subject broker and another broker. The investigator then reviewed the Potential Accommodation Trading Report for the next six months to determine if there was a pattern of accommodation trading between the brokers. The investigator identified only two instances of the subject broker trading for his personal account opposite the other broker trading for a customer account, and therefore, closed the investigation with no further action.

Finally, Investigation 2001-237(a) is an example of a complex investigation in which analysis of a member's profits and losses contributed to a BCC finding of numerous rule violations and an order for customer restitution. The investigation identified numerous instances of non-competitive trading over a 12-day period, including illegal cross trades, misuse of error cross trades, and mechanical adjustments by which the subject broker either took the opposite side of customer orders or traded ahead of customer orders.<sup>35</sup> The Compliance Department calculated that the broker's net profits from these transactions totaled \$113,314 and that customer harm totaled \$9,918. The matter was referred for disciplinary action and the BCC directed that charges be issued.<sup>36</sup>

---

<sup>35</sup> The investigation report included detailed analyses for 21 instances of trading ahead of customer orders.

<sup>36</sup> While that case was pending (the member had rejected two settlement offers and the Exchange was in the process of scheduling a hearing), another investigation (Investigation 2002-049) involving the same member was referred to the BCC. That investigation concluded that the member once again misused error accounts and transacted illegal cross trades to trade ahead of customer orders. The Compliance Department calculated that the member profited by \$10,000 from the illegal trades and that customers were harmed in the amount of \$10,000. The Exchange combined Investigations 2001-237(a) and 2002-049 with another investigation that was referred to the BCC (Investigation 2002-136) in which it was alleged that the same member violated the Exchange's lessee requirements. The three investigations were rolled into a single case (Investigation 2003-084) that was settled shortly after the end of the target period. As discussed below at p. 37, the member was fined \$125,250, suspended for 13 months, ordered to pay \$20,000 in customer restitution, and permanently barred from executing customer orders.

### 3. Cross Trade Investigations

The Division also found that the Exchange's cross trade investigations were thorough. Compliance Department staff ensured that cross trades were witnessed by exchange employees, that the Exchange's cross trade recordkeeping requirements were satisfied, and that there was separate account ownership for purposes of identifying possible wash trades.<sup>37</sup> Exchange rules prohibit a broker from crossing orders for the same principals, or crossing customer orders with his or her own account, an account that he or she controls, or an account for another member on the floor. As a result, most cross trades at CSCE involve customers on both sides of the trade, house accounts on both sides, or house accounts opposite customers.

As previously stated, cross trade reviews generally are conducted monthly based on a visual review of the Exchange's monthly cross trade reports by senior Compliance Department staff.<sup>38</sup> During this review, particular attention is given to cross trades with the following characteristics: (1) the same clearing member appears on both sides of a house account vs. customer account cross trade, (2) the same clearing member appears on both sides of a cross trade with the same account identifier on the buy and sell side, (3) the account identifier for the buy and sell side are different but appear to be closely related in name or number sequence, (4) it appears that a buy or sell involving an account for which the broker has an interest is crossed with a customer order, (5) a trade crossed at a suspiciously high or low price, (6) large quantity

---

<sup>37</sup> CSCE Rule 3.13, the Exchange's cross trade rule, requires that orders must first be offered to the floor before being crossed and that cross trades be witnessed by an Exchange employee. After witnessing a cross trade transaction, the Exchange employee prepares a cross trade slip and records the identity of the executing broker and the quantity, delivery month and price for futures contracts, or, if the transaction involves option contracts, the quantity, delivery month, strike price, premium, and put or call. The employee then initials and timestamps the cross trade slip to the nearest minute of execution. When executing a cross trade, brokers must identify the cross trade on their trading card and record the time of execution.

<sup>38</sup> The monthly cross trade report for each commodity is a compilation of daily cross trade reports. Cross trade investigations also can be initiated from review of the Daily Trade Register.

cross trades, and (7) cross trades executed in back month contracts. Once a particular trade is selected for further review, an investigator is assigned to examine the trade. If a trade remains suspicious after the investigator's initial review, an investigation is opened.

The Exchange closed 15 cross trade investigations during the target period, 11 which involved the same clearing member and same account identifier on both sides of the trade, two which appeared to involve the broker's interest on one side of the trade, and two which involved large-size cross trades. The primary focus of the Exchange's cross trade investigations is to determine whether the same principals are on the buy and sell side of the subject trade, indicating possible wash trading. For example, Investigation 2002-142 concerned a 30-lot December 2002 coffee trade in which it appeared that the broker crossed orders for the same customer account at the same clearing member. However, after account statements were requested from the clearing member, trading records were analyzed, and interviews were conducted, the Exchange found that the firm mistakenly cleared both sides of the trade to its error account after attempting to correct an error in filling a spread trade for a customer. In fact, only one side of the cross trade should have been cleared to the house error account, with the other side going to the customer account. Based on this information and the fact that the firm volunteered to take remedial action, no further action was taken with respect to the firm. However, the broker who crossed the orders on the Exchange floor was issued a warning letter for not questioning the same account identification on both orders.<sup>39</sup>

---

<sup>39</sup> That broker also is the principal of the member firm that received the orders on the Exchange floor. The member firm received a warning letter for violating CSCE Rule 1.28A which requires that members receiving customer orders on the Exchange floor immediately prepare an order ticket that includes, among other things, the account identification. The Exchange found that proper account identifiers were not recorded on the order tickets, but rather only contained the indicator "L" for a London affiliate.

In addition to evaluating the adequacy of cross trade investigations, the Division examined several months of the Exchange's cross trade reports to determine whether the CSCE opened a sufficient number of cross trade investigations given the large number of cross trades executed on the Exchange.<sup>40</sup> Although the Division found that the cross trade investigations completed by the Exchange were thorough and well documented, the Division is concerned that the Exchange opened only two cross trade investigations involving large quantities, one of the Exchange's review criteria.<sup>41</sup> Large-size cross trades can be indicative of noncompetitive trading.<sup>42</sup>

The Division's review of the Exchange's cross trade reports revealed numerous cross trades that the Exchange did not investigate that the Division believes should have been pursued based on the large size of the trades. For example, on August 15 and 29, 2002, 500-lot cross trades were executed in September 2003 and December 2003 cocoa futures, respectively. In addition, on September 6, 2002 and February 4, 2003, 500-lot cross trades were executed in October 2002 and March 2003 sugar futures, respectively. On February 7, 2003, two separate

---

<sup>40</sup> As calculated by the Exchange for three representative dates in March, 2004, cross trades in the two most active months accounted for 10 percent of the volume in cocoa futures, seven percent in coffee futures and five percent in sugar futures for those months. For purposes of its examination, the Division reviewed the September 2002 and February and April 2003 cross trade reports for sugar futures; the July 2002 and January and February 2003 cross trade reports for sugar options; the July 2002 and February and April 2003 cross trade reports for coffee futures; the October and December 2002 and May 2003 cross trade reports for coffee options; the August 2002 and February, April, and May 2003 cross trade reports for cocoa futures; and the July, August, and October 2002 cross trade reports for cocoa options. In addition, the Division reviewed cocoa futures daily cross trade reports for June 11, 12, 13, 14, 17, 18, and 19, 2002; November 6, 2002; July 10, 22, and 23, 2002; August 16, 2002; and January 6, 2003.

<sup>41</sup> In Investigation 2002-096, the Exchange examined two 100-lot cocoa option cross trades. The Exchange found that the buy and sell side of each trade was executed for unrelated principals, and that the crosses were witnessed by an Exchange official. The broker, however, was issued a warning letter for order ticket violations. In Investigation 2002-097, the Exchange examined two 250-lot cocoa option cross trades. Staff found that the buy and sell side of each trade was executed for separate principals, however, the broker was issued a warning letter for failing to report one of the two cross trades.

<sup>42</sup> For example, large size cross trades that involve the same firm or customer on both sides of the trade can be indicative of prearranged or wash trading.

492-lot cross trades in March 2003 sugar futures were executed, and on May 19, 2003, a 1,500-lot cross trade was executed in September 2003 cocoa futures.

In addition, the Division identified numerous small-size cross trades (5 lots or less) executed by a small number of brokers in either the spot or first nearby month, which it believes should have been examined to ensure that the brokers complied with the Exchange's cross trade rules. The Division believes that small orders offered to the market in liquid contract months typically should be able to be filled without a broker crossing the orders and that brokers who execute a significantly large number of small size cross trades should be subject to further review.

For example, the Division found that a single broker, "Broker A," executed the largest amount of small-size cross trades in the spot or the first nearby month in coffee futures for the three sample months of coffee that were reviewed. In February 2003, Broker A executed a total of 284 small-size cross trades in the spot or first nearby month (205 in the spot month and 79 in the first nearby month). Broker A also executed the largest number of small-size cross trades in the spot or first nearby month on any single given day during the February 2003 trading period. Specifically, on February 19, 2003, Broker A executed a total of 40 small-size cross trades in either the spot or first nearby month (24 in the spot month and 16 in the first nearby month). Similarly, on February 14, 2003, Broker A executed a total of 33 small-size cross trades in either the spot or first nearby month (17 in the spot month and 16 in the first nearby month).<sup>43</sup>

---

<sup>43</sup> Broker A was equally active in the other two coffee months reviewed by the Division, July 2002 and April 2003. In July 2002, Broker A executed a total of 196 small-size cross trades in the spot month or first nearby contract (103 in the spot month and 93 in the first nearby month). Broker A also executed the largest number of small-size cross trades in the spot month or first nearby month contract on any given day during the July 2002 trading period. In that respect, on July 19, 2002, Broker A executed a total of 30 small-size cross trades in either the spot month or first nearby month contract (12 in the spot month and 18 in the first nearby month). In April 2003, Broker A executed a total of 278 small-size cross trades in the spot month or first nearby contract (74 in the spot month and 204 in the first nearby month). Broker A also executed the largest number of small-size cross trades in the spot month or first

In sugar futures, the Division found that three brokers were primarily responsible for executing the largest number of small-size sugar futures cross trades in either the spot or first nearby month. In September 2002, Broker B executed a total of 231 small-size cross trades in the spot or first nearby month (21 in the spot month and 210 in the first nearby month). The largest number of these trades were executed on September 20, 2002, when Broker B executed 26 small-size cross trades in the first nearby month. On the same date, Broker C filled the largest amount of small-size cross trades in either the spot or first nearby month for a given day in September, executing 30 in the first nearby month. In February 2003, Broker D was responsible for the largest number of small-size cross trades executed in either the spot or first nearby month, a total of 162 trades (74 in the spot month and 88 in the first nearby month). Broker D also executed the largest number of small-size cross trades in the spot or first nearby month on any single day during February 2003, executing 21 such cross trades in the first nearby month on February 24.<sup>44</sup>

To facilitate the examination of the types of cross trades identified by the Division, in lieu of manually reviewing lengthy cross trade reports, which can exceed 50 pages for a single commodity, the Division recommends that the Exchange develop an automated cross trade exception report that isolates and identifies the various types of suspicious cross trades that may merit further examination.

---

nearby month contract on any given day during the April 2003 trading period. In that respect, on April 17, 2003, Broker A executed a total of 48 small-size cross trades in either the spot month or first nearby month contract (15 in the spot month and 33 in the first nearby month).

<sup>44</sup> Broker D also executed the greatest number of small-size cross trades in either the spot month or first nearby contract month in April 2003. In this connection, Broker D executed a total of 124 small-size cross trades in the spot month or first nearby contract (94 in the spot month and 31 in the first nearby month). In addition, Broker D executed the largest number of small-size cross trades in the spot month or first nearby contract month on any single given day during the April 2003 trading period. In this regard, on April 16, 2003, Broker D executed a total of 27 small-size cross trades in either the spot month or first nearby contract month (10 in the spot month and 17 in the first nearby contract month).

## **E. Conclusions and Recommendations**

The Division found that the Exchange generally maintains an adequate trade practice surveillance program. However, the Division found one aspect of that program, the Exchange's procedures for monitoring compliance with cross trade rules, that should be enhanced.

On a daily basis, the Compliance Department uses computerized surveillance and floor surveillance as a means of detecting and investigating potential trade practice violations. The Exchange opened 80 and closed 111 investigations during the target period, the vast majority of which were internally generated from routine reviews of automated surveillance reports. The Division reviewed each of the closed investigations and found that they were thorough, well documented and completed in a timely manner.

The Division also found that since the 1999 Review, the Exchange has made several enhancements to its investigation procedures. First, the Exchange has expanded the scope of its investigations by examining all of a subject member's trading cards and order tickets for the entire day(s) that suspect trades occurred. Second, rather than focusing on just the exceptions generated by computerized reports, investigators routinely expand their inquiries to include a subject member's trading over a period of time to establish a pattern of trading violations. Third, investigation reports commonly include calculation of members' profits and losses and customer losses.

With respect to cross trades, the Division found that 15 of the investigations closed during the target period were generated from routine cross trade reviews, only two of which involved large-size cross trades. Large-size cross trades are one of the Exchange's criteria for opening an investigation. The cross trades investigations resulted from manual reviews of lengthy computer reports, that can exceed 50 pages for a single commodity, that list monthly



cross trades for a subject market. As with other investigations, these investigations were thorough, well documented, and completed in a timely manner. Compliance staff ensured that the subject cross trades were witnessed, that the Exchange's cross trade recordkeeping requirements were satisfied, and that there was separate account ownership for purposes of identifying possible wash trades.

However, in conducting an independent review of several months of the Exchange's cross trade reports, the Division identified numerous large-size cross trades that it believes should have been investigated based on the size of the trades to ensure that they did not involve noncompetitive trading. The Division also identified numerous small-size cross trades executed by a small number of brokers in liquid contract months that it believes should have been examined to ensure that the brokers complied with the Exchange's cross trade rules. Given that small-size orders offered to the market in liquid contracts typically should be able to be filled without a broker crossing orders, brokers who execute a significantly large number of small-size cross trades should be subject to further review.

Finally, the Division found that the Exchange's Floor Surveillance Log reflected few entries for its option markets. Therefore, the Division was unable to determine if floor surveillance was conducted for those markets.

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

- **Increase the number of large-size cross trades it investigates and develop procedures to examine brokers who execute a large number of small-size cross trades in liquid contract months. In addition, the Exchange should develop an automated exception report that identifies cross trades that meet the Exchange's criteria for further review.**
- **Document floor surveillance conducted for its option markets.**

## V. DISCIPLINARY PROGRAM

### Core Principle 2 – Compliance with Rules:

**The board of trade shall monitor and enforce compliance with rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.**

As noted earlier, Core Principle 2 requires, among other things, that an exchange have the authority to discipline, suspend, or terminate the activities of members or market participants pursuant to clear and fair standards. Consequently, an acceptable compliance program should provide for prompt and effective disciplinary action for any violation that is found to have been committed.

#### A. Disciplinary Committees and Procedures

The BCC is the CSCE's primary disciplinary committee. During the target period, each NYBOT exchange maintained its own BCC. In June 2003, the NYBOT Board consolidated the individual exchanges' BCCs into a single NYBOT BCC. The NYBOT BCC is comprised of 34 individuals divided into two subcommittees, each chaired by either the Chairman or Vice-Chairman. Each subcommittee includes 17 individuals, including 12 floor members, two each from the coffee, sugar, cocoa, cotton, and orange juice markets, and one each from FINEX and NYFE markets; three individuals identified with FCM/trade membership interests; and two non-members.<sup>45</sup>

The BCC serves two functions, one is to determine whether there is a reasonable basis to believe that an alleged rule violation may have occurred and the other is to conduct adjudicatory

---

<sup>45</sup> An alternate floor member is designated for each of the coffee, sugar, cocoa, cotton, orange juice, FINEX and NYFE rings. Two alternate FCM/trade members also are designated. These alternates are available to serve on either subcommittee.

hearings for contested cases. The two BCC subcommittees alternate meetings, with one subcommittee responsible for determining whether there is “probable cause” to find that a rule violation occurred, and members of the other subcommittee serving on a hearing panel if the case is contested.

When a subcommittee is convened to make probable cause determinations, the subcommittee chair selects an eight-member panel. The panel includes four floor members, two from the relevant ring, except for FINEX and NYFE, which have one floor member each; three members from the FCM/Trade category; and one non-member.<sup>46</sup> If there is a need to convene a hearing panel, the BCC Chairman has the discretion to appoint either a three or five-person panel. A three-person hearing panel includes one FCM/Trade member, one floor member, and one non-member. A five-person hearing panel includes two FCM/Trade members, two floor members, and one non-member.<sup>47</sup>

The Compliance Department is responsible for investigating possible rule violations and preparing investigation reports. If the Vice President of Compliance concludes that a rule violation may have occurred, he may issue a warning letter or negotiate and enter into a settlement agreement, subject to BCC approval, at any time prior to a BCC meeting to determine probable cause.<sup>48</sup> If a case is referred to a BCC subcommittee for a probable cause determination, a meeting is scheduled and the subcommittee panel is provided with the investigation report six to ten days prior to the meeting. The member who is the subject of the matter also is provided with a copy of the investigation report and given the opportunity to

---

<sup>46</sup> CSCE Rule 26.03(b). Whenever a meeting is convened to hear cases for probable cause determinations, floor trading cases for no more than two products will be presented at the meeting.

<sup>47</sup> CSCE Rule 26.08.

<sup>48</sup> CSCE Rule 26.02(d).

respond in writing no later than five days prior to the scheduled meeting.<sup>49</sup> The member also may address the BCC subcommittee at the meeting. The subcommittee may refer a case back to the Compliance Department for further investigation, or, if the subcommittee concludes that a rule violation may have occurred, authorize the issuance of a Notice of Charges, enter into a settlement agreement with the member, or refer the matter for a hearing.<sup>50</sup>

CSCE rules authorize the Compliance Department and the BCC to negotiate and enter into settlement agreements that provide for a combination of the following sanctions: (1) a cease and desist order or a reprimand; (2) a fine not exceeding \$10,000 if entered into by the Compliance Department, or \$25,000 if entered into by the BCC, for each rule violation alleged plus the monetary value of any benefit received as a result of the alleged violation; (3) a suspension of up to three months for each rule violation alleged if entered into by the Compliance Department, or up to one year if entered into by the BCC; (4) expulsion; or (5) as part of a suspension or expulsion, an agreement that a member may not be employed by another member. In any matter in which a determination is made that as a result of a member's rule violation a customer incurred financial harm, the Compliance Department or the BCC may include restitution as a term of a settlement agreement.<sup>51</sup>

If a BCC subcommittee panel determines that there is probable cause to believe that a rule violation may have occurred, and a settlement cannot be achieved, it directs the Compliance Department to issue a Notice of Charges. Upon receiving a Notice of Charges, a respondent must request a hearing within 20 days or the right to a hearing is deemed waived. In addition, if a respondent does not file an answer within 20 days, the failure to answer is considered an

---

<sup>49</sup> CSCE Rule 26.02(c).

<sup>50</sup> CSCE Rule 26.03.

<sup>51</sup> CSCE Rules 26.02(d)(ii) and 26.03(d)(iv).

admission to all of the allegations set forth in the Notice of Charges. The Compliance Department may reply to a respondent's answer within five days of receiving an answer.<sup>52</sup>

Prior to the commencement of a hearing, a hearing panel may approve the entry into a settlement agreement with a respondent. If a case is not settled and a hearing is convened, the respondent has the right to be represented by legal counsel, to present witnesses and documentary evidence, and to cross-examine witnesses. The hearing panel's written decision must include a summary of the allegations contained in the notice of charges, a summary of the respondent's answer, a brief summary of the evidence, and a statement of findings and conclusions with respect to each charge. If a hearing panel finds a respondent guilty of any charge, the written decision must include the specific rule that the respondent was found to have violated. If the violation involved the execution of a customer transaction, the hearing panel must make a finding as to whether the customer incurred financial harm. The decision also must contain an order stating the penalty imposed. The imposed penalty may include any of the following: (1) a cease and desist order or a reprimand; (2) a fine not exceeding \$100,000 for each rule violation plus the monetary value of any benefit received as a result of the violation; (3) a suspension of up to one year for each rule violation; (4) expulsion; (5) as part of a suspension or expulsion, an agreement that the respondent may not be employed by another member; and (6) restitution to injured customers.<sup>53</sup>

Another committee with sanctioning authority, the Floor Committee, may issue summary fines not exceeding \$5,000 for violation of any rule regarding decorum; the timely submission of

---

<sup>52</sup> CSCE Rules 26.06 and 26.07.

<sup>53</sup> CSCE Rules 26.11, 26.12, and 26.13.

accurate reports, records, or other similar matters required for clearing and verifying trades; or enumerated floor trading practice violations.<sup>54</sup>

## **B. Adequacy of Sanctions**

During the target period, the Compliance Department referred nine cases involving ten members to the BCC for disciplinary action.<sup>55</sup> Eight of the nine cases settled during the target period and the remaining case settled shortly after the target period. All of the cases were resolved in a timely manner. In this connection, the Compliance Department promptly referred the cases to the BCC, typically within seven to 14 days of an investigation's close date. All of the cases were settled in a time period ranging from one to six months.

The nine cases resulted in a BCC warning letter and fines totaling \$143,500, including \$12,750 for recordkeeping violations and \$130,750 for substantive trade practice violations. In addition, three members were ordered to pay customer restitution totaling \$23,149. Six of the nine cases involved recordkeeping violations and three of the cases involved substantive trade practice violations that included trading ahead and trading against customer orders, misallocation of customer orders, non-competitive trading, misuse of error accounts, and illegal cross trades.

---

<sup>54</sup> CSCE Rule 26.25. The enumerated floor practice trading offenses include: (1) offering into bids; (2) offering over existing offers; (3) bidding into offers; (4) bidding under an existing bid; (5) improperly approaching the market; (6) causing an incorrect price to be disseminated by the Exchange; (7) bidding, offering, or executing a trade after a suspension of trading has been declared; (8) bidding, offering, or executing a trade (i) in any delivery month during an opening or closing call after the caller has declared trading in such delivery month to have ended, or (ii) in any contract during an opening or closing call after the caller has declared trading to be closed; (9) failing to conform to the procedures set forth in CSCE Rule 3.13 concerning the proper execution of cross trades; and (10) reneging a bid or offer after acceptance by another floor member. The minimum fine for any of these offenses is \$250.

<sup>55</sup> As noted above, all of the Exchange's records, including all ongoing investigations, were destroyed in the September 11, 2001 New York terrorist attack. Exchange staff explained to the Division that the records included some investigations that staff were preparing to refer for disciplinary action.

As noted earlier, the Exchange levied a \$125,250 fine as part of the settlement of Investigation 2001-237(a).<sup>56</sup> This is the largest fine in Exchange history. The member was also suspended for 13 months, prohibited from being on the NYBOT trading floor or working for another member during the suspension, barred for life from executing customer orders, and ordered to pay \$20,000 in customer restitution.<sup>57</sup> The two other fines imposed for substantive trade practice violations during the target period arose from cases involving trading ahead of customer orders. The settlement agreement for Investigation 2002-008 included a \$5,000 fine and a \$2,793 payment for customer restitution. The settlement agreement for Investigation 2001-224 included a \$500 fine and a \$356 payment for customer restitution. Given the seriousness of trading ahead of customer orders and the similarity of the two cases, the Division believes that the penalty levied in Investigation 2001-224 was insufficient.

In Investigation 2002-008, the Compliance Department identified two instances for which it found a reasonable basis to believe that the subject broker traded ahead of an executable customer order.<sup>58</sup> In Investigation 2001-224, the Compliance Department found three instances in which the subject broker traded ahead of five executable customer orders.<sup>59</sup> The Division

---

<sup>56</sup> See p. 24, for a discussion of Investigation 2001-237(a).

<sup>57</sup> In connection with this case, another member was fined \$10,000 for failing to retain original floor order tickets. The Compliance Department noted in its Investigation Report that this interfered with its reconstruction of the subject broker's trading. Investigation 2001-237(b).

<sup>58</sup> The two identified trades involved the filling of a 10-lot customer order. The Compliance Department calculated that in the first trade (which involved 9 lots) the customer was harmed in the amount of \$2,531.25. In the second trade (which involved one lot) the customer was harmed in the amount of \$262.50.

<sup>59</sup> The investigation was generated from a customer complaint regarding trading on October 26, 2001. The broker claimed that it was possible that he did not have the orders in his possession until after he executed the trades for his personal account. However, four of the five orders were timestamped "in" on the floor more than one hour before they were elected.

The Division also notes that the member was one of six CSCE members charged in an administrative action filed by the Commission on July 9, 2002. The complaint alleged, among other things, that, from January 2000 through October 2000, the member (1) traded for his own account directly and indirectly opposite customer orders; (2) traded ahead of customer orders on the same side of the market and allocated trades to his personal accounts at

recognizes that there may be different degrees of trading ahead depending on the fact pattern present in each case. However, the Division did not identify a significant difference between these two cases such that it would justify the disparate sanctions, nor was there anything instructive in the BCC minutes in this regard.<sup>60</sup> Trading ahead of customer orders, regardless of the amount of customer harm, should be considered a serious violation of Exchange rules warranting the imposition of a meaningful penalty to deter recidivist activity and to discourage others from engaging in similar activity.

### **C. Conclusions and Recommendations**

Based upon its review, the Division found that the Exchange maintains adequate disciplinary procedures. In addition, disciplinary actions were completed in a timely manner. During the target period, the Compliance Department referred nine cases to the BCC that resulted in fines totaling \$143,500 levied against nine members and customer restitution totaling \$23,150. Although the BCC imposed the largest fine in Exchange history, \$125,250, which was coupled with other sanctions including a 13-month suspension and a lifetime ban on executing

---

better prices than those received by his customers; (3) reported non bona fide prices; (4) traded noncompetitively and entered into illegal wash sales and accommodation trades; and (5) failed to record required trade information on trading cards. The complaint also made several allegations of fraud and deception. In October 2003, approximately six months following the settlement of Investigation 2001-224, the administrative complaint was resolved pursuant to a settlement agreement. The member was ordered to cease and desist from engaging in the alleged illegal activity and to pay a \$30,000 civil penalty. In addition, the member's registration as a floor broker was suspended for three months and the member is barred from executing customer trades.

<sup>60</sup> The BCC minutes for Investigations 2002-008 and 2001-224 revealed that the offers that were ultimately accepted by the subject brokers were made by the BCC at the respective meetings.



customer orders, the Division identified a case involving trading ahead of a customer orders in which it believes that the sanction was insufficient given the seriousness of the violation.

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

- **Impose consistently meaningful sanctions in similar cases involving substantive trading abuses.**

## **VI. DISPUTE RESOLUTION PROGRAM**

### **Core Principle 13-Dispute Resolution**

**The board of trade shall establish and enforce rules regarding and provide facilities for alternative dispute resolution as appropriate for market participants and any market intermediaries.**

Pursuant to acceptable practices set forth in Appendix B to Part 38, an exchange is required to provide customer dispute resolution mechanisms that are fair, equitable, and available on a voluntary basis. Customers should have the opportunity to have their claims heard and decided by an objective and impartial decision maker. In addition, each party should have the right to counsel and be provided with adequate notice of claims presented against him or her and an opportunity to be heard on all claims, defenses, and counterclaims. The process should provide for a prompt hearing, as well as prompt, written, final settlement awards that are not subject to appeal within the exchange. The parties also should be notified of the fees and costs that may be assessed. Finally, if an exchange provides procedures for the resolution of member-to-member disputes (not involving customers), the procedures for resolving such disputes must be independent of and not interfere with the resolution of customers' claims or grievances.

#### **A. Customer Arbitration**

Exchange customers are afforded voluntary dispute resolution through the Exchange's arbitration rules, CSCE Rules 6.00 through 6.08. The rules provide customers the opportunity to

have their claims or grievances against a member or its employees heard by a panel of disinterested persons selected by the Chairman of the Arbitration Committee.

Any customer desiring to submit a matter for arbitration must notify the Exchange in writing within two years of the claim or grievance arising. Once the Exchange receives the written notice, the customer is provided with an arbitration package that includes the Exchange's arbitration rules and a Notice of Arbitration form ("Notice"). If the customer wishes to pursue the matter, he or she must submit a completed Notice within two years of when the claim or grievance arose or within 30 days of receiving the Exchange's arbitration package, whichever is later. A completed Notice must include the name and address of the party or parties against whom the claim is being asserted, its nature and substance, the relief requested, and the factual and legal bases alleged to underlie such relief. The Notice must be accompanied by payment of a non-refundable arbitration fee ranging from a minimum of \$100 for claims up to \$5,000 to a maximum of \$1,150.00 plus one-half percent for claims in excess of \$100,000.

Upon receipt of a completed Notice and appropriate arbitration fee, the Exchange serves copies on all named Respondents, who have 20 days to file an answer setting forth their positions with respect to the alleged claims or grievances. Any allegation not denied is deemed admitted. The answer also may set forth any counterclaims that arise out of the transaction or occurrence that is the subject of the customer's claim or grievance. Customers have 20 days to respond to any such counterclaims.

Upon receipt of the answer, the Chairman of the Arbitration Committee appoints an arbitration hearing panel and selects a panel Chairman to decide the claim or grievance.<sup>61</sup> Three-

---

<sup>61</sup> When filing a Notice, the customer must elect whether he or she would want to have the claim heard by a "mixed panel," where at least a majority of the panelists are not members or associated with any member of a contract market or associated with a contract market, or a panel composed of committee members.

person panels are used if the relief requested does not exceed \$100,000; five-person panels are used for larger claims. If neither the alleged claims nor counterclaims total \$5,000, the Chairman of the Arbitration Committee may, at his sole discretion, determine that the matter will be resolved on the basis of written submissions alone.

Arbitration proceedings are held at a time and place determined by the hearing panel. Each party has the right to be represented by counsel. In addition, each party has the right to appear personally at the hearing; prepare and present relevant facts and rebuttal evidence; examine the other parties; examine any witnesses appearing at the hearing; and examine all relevant documents presented in connection with the claim or grievance, or any defense or counterclaim.

A hearing panel must issue a written decision within 60 days following the conclusion of a hearing. Exchange rules provide that the panel may grant any remedy or relief it deems just and equitable, including the award of the arbitration fee and interest. Any costs incurred as a result of having a mixed panel are born by the member unless the panel finds that the customer acted in bad faith in initiating or conducting the proceeding.

## **B. Member-to-Member Arbitration**

The Exchange's member-member arbitration procedures generally are similar to those for customer arbitration. Disputes between Exchange members must be settled by Exchange arbitration when the dispute involves an "allowable claim." Allowable claims are those that arise directly from (1) any futures or option transaction executed, or to be executed, on or subject to the rules of the Exchange or (2) any cash transaction directly related to a futures or option transaction executed on or subject to the rules of the Exchange. Members may not elect a mixed

panel to hear their claim. Any award not complied with within the time specified is enforceable by Exchange disciplinary proceedings. Member-to-member arbitrations are independent of customer-member arbitrations and may not interfere with or delay them.

### **C. Arbitrations During the Target Period**

There was one customer-member arbitration and one member-member arbitration during the target period. Commission staff's review of the respective files found that the disputes were handled in conformance with the Exchange's arbitration rules and procedures, and were completed in a timely manner.

### **D. Conclusions and Recommendations**

The Division finds that the Exchange's arbitration rules provide for fair and equitable procedures for the resolution of customer and member disputes. Customers have the opportunity to have their claims heard by disinterested panels, including panels where a majority of the panelists are not members or associated with any member of a contract market, or otherwise associated with a contract market. Each party has the right to counsel. Each party also receives adequate notice of the claims presented against it, has the right to counsel, and has an opportunity to present all claims, defenses, and counterclaims. In addition, the Exchange's arbitration procedures require a prompt hearing and authorize prompt, written, awards by panels with authority to issue awards or any remedy or relief they deem just and equitable.

The Exchange also provides adequate procedures for mandatory member-member arbitration, and for disciplinary action to enforce panel decisions. In addition, member-member arbitration is separate from and independent of customer claims submitted for resolution and

does not interfere with or delay customer disputes. Finally, the two disputes decided during the target period were resolved in accordance with Exchange rules and procedures.

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