

**RULE ENFORCEMENT REVIEW
OF
ICE FUTURES U.S.**



**Division of Market Oversight
July 22, 2014**

**Rule Enforcement Review of
ICE Futures U.S. (“ICE Futures” or “Exchange”)
Market Surveillance Program
Commodity Futures Trading Commission – Division of Market Oversight**

Target Period: June 15, 2011 to June 15, 2012

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I. INTRODUCTION¹

The Division of Market Oversight (“Division”) of the Commodity Futures Trading Commission (“Commission”) has completed a rule enforcement review of the market surveillance program of ICE Futures U.S. (“ICE Futures” or “Exchange”). The review covers the period from June 15, 2011 to June 15, 2012 (“target period”). Although the Division’s review primarily focused on the target period, in its analysis and recommendations the Division took into account post-target period changes in the Exchange’s market surveillance program.

The Division’s review focused on compliance with two core principles under Section 5(d) of the Commodity Exchange Act (“CEA”), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).² In particular, the Division’s review focused on Core Principles 4 (Prevention of Market Disruption) and 5 (Position Limitations or Accountability), which relate to an exchange’s market surveillance program. As set forth below,

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

² See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010). The effective date of the Dodd-Frank Act was July 16, 2011, approximately a month after the beginning of the target period. As a result, the Division’s review focused on Sections 5(d)(4) and 5(d)(5) of the CEA, as amended by the Dodd-Frank Act, because the new Core Principles 4 and 5 were in effect for approximately eleven months of the target period. Furthermore, on May 10, 2012, the Commission issued its Final Rules, *Core Principles and Other Requirements for Designated Contract Markets*, 77 Fed. Reg. 36612 (June 19, 2012), which became effective on October 17, 2012, after the target period. Among other things, this rulemaking revised guidance and acceptable practices for some core principles and, for several core principles such as Core Principles 4 and 5, codified rules in lieu of guidance and acceptable practices. See 77 Fed. Reg. 36,612, 36,614, 36,702-03. Because these rules were not in effect during the target period, the Division evaluated the Exchange’s market surveillance program under the pre-existing guidance and acceptable practices, while noting where applicable whether certain aspects of the program are consistent with the guidance and acceptable practices implemented by the Final Rules.

the Division is making several recommendations for further action by the Exchange, including recommendations with respect to the procedures governing the Exchange's Regulatory Oversight Committee, the Exchange's market surveillance staffing, and the processes by which the Exchange regulates open interest reporting and evaluates applications for hedge exemptions.

Core Principles Following Amendment of the CEA by the Dodd-Frank Act

Core Principle 4 – Prevention of Market Disruption:

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

- a) methods for conducting real-time monitoring of trading; and**
- b) comprehensive and accurate trade reconstructions.**

Core Principle 5 – Position Limitations or Accountability:

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

An acceptable market surveillance program should regularly collect and evaluate market data to determine whether markets are responding to the forces of supply and demand. An exchange should also have routine access to the positions and trading of its market participants ("MPs"). This data should be evaluated on a daily basis to enable the exchange to respond appropriately to potential market disruptions or abusive practices. An effective surveillance program for an exchange with multiple products and a substantial number of MPs should include an automated large trader reporting system.

To facilitate orderly liquidation of expiring contracts and minimize the potential for expiration problems arising from excessively large positions, an exchange may need to establish position limits for some commodities, although it may substitute position accountability for

position limits where the threat of excessive speculation or manipulation is nonexistent or very low. Spot month limits should be adopted for commodities that have more limited deliverable supplies, or where necessary to minimize a market's susceptibility to manipulation or price distortion. Position limit rules may provide for hedge or other exemptions, and may set limits differently by markets, delivery months, or time periods. An exchange should have an effective program for enforcement of position limits, and should monitor the continuing appropriateness of approved exemptions. An exchange should also have an effective program for taking regulatory action when a violation of a position or exemption limit is detected, regardless of whether the violation is by a member or non-member.

For purposes of this review, Division staff interviewed compliance officials and staff from the Exchange's Market Regulation Department ("Market Regulation"), of which the Market Surveillance Department ("Market Surveillance" or "MSD") is a subset. During the interview, the Division received a demonstration of several electronic tools used by the Exchange to conduct market surveillance. The Division also reviewed numerous documents used by Market Surveillance in carrying out the Exchange's market surveillance responsibilities, or produced for purposes of describing those responsibilities in connection with this rule enforcement review. These documents included, among other things, the following:

- the market surveillance procedures manuals, rulebooks and guidelines of the Exchange and of the Exchange's clearinghouse, ICE Clear U.S. (the "Clearinghouse");
- the Bylaws of the Exchange;
- minutes of all meetings of the Exchange's committees responsible for market surveillance matters that were held during the target period;
- documents describing the automated surveillance systems used by the Exchange to conduct market surveillance;
- automated computer reports and other documents generated by the Exchange's market surveillance tools;
- files and records concerning contract expirations, position accountability and speculative position limit enforcement, and applications for cash and carry exemptions and other exemptions from position limits;
- files and records concerning market surveillance-related case files and research files; and
- Clearinghouse assessment letters.

The Division provided the Exchange with an opportunity to review and comment on a draft of this report on May 27, 2014. On June 9, 2014, Division staff conducted an exit conference with MSD staff to discuss this report's findings and recommendations.

II. SUMMARY OF FINDINGS AND RECOMMENDATIONS

A. Market Surveillance Department Structure and Staffing

Findings

- MSD is a subset of the Market Regulation Department. In performing its surveillance function, MSD relies upon the Exchange’s Commodity Operations Department and ICE Clear U.S., an Exchange subsidiary that serves as its derivatives clearing organization. MSD also relies on product-specific Control Committees for guidance on market surveillance issues, such as position limit exemption requests.
- The Regulatory Oversight Committee (“ROC”) is comprised of the four directors who occupy the Board directorships designated in the Bylaws as the public director positions. No tie-breaking procedures are in place to resolve differences between the four members if a tie were to arise.
- MSD consisted of eight personnel at the end of the target period, out of 23 personnel overall in the Market Regulation Department. After the target period, the Exchange reassigned the duties of certain personnel in an effort to reduce the time taken to complete surveillance investigations.

Recommendations

- The Exchange should implement tie-breaking procedures to resolve tie votes of the ROC, or alternatively, the Exchange should ensure that the committee is composed of an odd number of members greater than one.
- The Exchange should ensure that MSD maintains staffing sufficient to perform all of its surveillance responsibilities, including timely completion of surveillance investigations.

B. Market Surveillance Procedures and Systems

Findings

- MSD’s principal tool for monitoring positions held by large traders in the Exchange’s various markets is the Market Surveillance Application, which maintains large trader data on futures and options positions, along with account identification data, delivery notices, and other relevant information. MSD complements the Market Surveillance Application with SMARTS, a third-party surveillance application that enables MSD to monitor and review trading in a graphical format on a real-time basis.

- MSD generates a number of reports through the Exchange’s “Crystal” application for purposes of monitoring market fundamentals. These include the Top Day Alert Report and Over Limits Alert Report, which MSD reviews to identify MPs that are near or above their position limits or position accountability levels. MSD also reviews various reports through the Exchange’s public Report Center, including a Daily Volume and Open Interest report and a Historical Monthly Volume report.
- In order to monitor for open interest, MSD reviews two Crystal reports: the Firm Positions vs. Open Interest (OI) Spreadsheet and the OI vs Position Alert Spreadsheet. The OI vs Position Alert Spreadsheet was introduced in September 2013, following the end of the target period.

Recommendations

- The Division does not have any recommendations in this area.

C. Routine Surveillance of Market Fundamentals

Findings

- The Exchange does not have specific protocols in place that establish when it will address misreporting of open interest in addition to or in lieu of the Clearinghouse. During the target period, both the Clearinghouse and Exchange brought sanctions for instances of misreporting of open interest, via Clearinghouse assessment letters and Exchange warning letters and sanctions, raising questions about which entity is responsible for investigating and sanctioning such misreporting.
- MSD uses a number of resources to analyze price and volume data, in order to detect unusual price movements, market congestion, or unusual volume activity, among other issues.
- MSD monitors deliverable supply to avoid situations in which there is insufficient supply of a commodity at expiration, which can cause the commodity contract to become susceptible to price manipulation or distortion. MSD routinely contacts MPs to inquire about deliverable supply in relation to upcoming contract expirations, reviews warehouse stock reports, and monitors market news and various reports for information that could impact deliverable supplies.

Recommendations

- If the Exchange intends to continue to sanction misreporting of open interest alongside the Clearinghouse, then the Exchange's rulebook should set forth specific rules stating that open interest misreporting represents a violation of Exchange rules. Any Exchange sanctions for the misreporting of open interest should be sufficient to deter recidivism.
- The role of Exchange staff in enforcing Clearinghouse requirements regarding open interest reporting should be formalized in the procedures manual of the Exchange. If the Exchange intends to continue sanctioning misreporting of open interest, it should maintain records of any sanctions also issued by the Clearinghouse so that it may properly account for recidivist behavior.

D. Surveillance of Expiring Contracts

Findings

- MSD conducts intensified surveillance of expiring contracts in order to detect and prevent price manipulation and facilitate orderly liquidations, focusing on large trader positions and position concentrations, and the relationship between deliverable supply and open interest.
- MSD monitors for price convergence in physically delivered contracts during contract expirations. According to MSD, it is inherently more difficult for MSD to monitor for price convergence in international soft products such as Coffee, Sugar and Cocoa, although MSD works with Control Committees and contacts large traders in an effort to monitor price convergence in these products.³
- The Exchange identified one contract expiration that required particular scrutiny during the target period: July 2011 Cotton futures contracts. In that instance, the Division determined that the Exchange responded appropriately to the expiration-specific market factors, ensured orderliness, and kept well-documented files.

Recommendations

³ The Division is continuing to review the Exchange's procedures with regard to monitoring for price convergence in the international soft products to determine if they are consistent with Commission regulation 38.252(a).

- The Division does not have any recommendations in this area.

E. Position Limits and Accountability Levels

Findings

- MSD monitors the size of participants' positions in order to enforce speculative position limits. MSD may also rely on position accountability levels to instruct an MP not to increase its position further and/or to reduce its position to the appropriate accountability level, due to liquidity concerns or other concerns regarding potential negative market impact.
- MSD may grant position limit exemptions for bona fide hedging, arbitrage and straddle transactions via written position limit request forms. Exchange Rule 6.27 permits Exchange members to apply for a cash and carry exemption in connection with arbitrage, spread and straddle strategies.⁴ This type of exemption is unique to the Exchange, and is not offered by other DCMs.
- The Exchange requires that MPs renew single month and all month hedge exemptions on an annual basis. MSD sends a letter to the MP in connection with this renewal, which requires the MP to submit a new application if relevant information has changed. If the MP does not respond to the letter, MSD cancels the exemption.
- The Division's review of several exemption requests provided by the Exchange shows that applicants sometimes do not fill out the form completely, *i.e.*, some questions are not answered, and the answers to some questions are not complete.
- Exchange Rule 6.26 requires that MPs submitting a request for a hedge exemption demonstrate that the proposed transactions are bona fide hedging transactions (as defined in Commission regulation 1.3(z)). Notwithstanding this Exchange Rule, the Exchange permits MPs to support a request for a hedge exemption with unfixed-price purchases and sales, which do not qualify as bona fide hedging transactions under Commission regulation 1.3(z). When Division staff called this inconsistency to the attention of Exchange representatives, they agreed to propose an amendment to the Exchange

⁴ The Division is continuing to review the effectiveness of the Exchange's cash and carry exemptions and the procedure by which the Exchange grants such exemptions.

Rulebook clarifying that the Exchange will offer hedge exemptions from the applicable Exchange position limits for positions that are determined by the Exchange to be consistent with the purpose of hedging, in addition to offering hedge exemptions for bona fide hedging positions, as defined in Commission regulation 1.3(z).

Recommendations

- The Exchange should require market participants to resubmit detailed information on at least an annual basis to support their single month and all month hedge exemptions.
- Prior to granting a hedge exemption, the Exchange must ensure that applicants complete each question in their exemption applications. The Exchange must also ensure that applicants provide sufficiently detailed information to allow the Exchange to analyze the underlying reasons for the request, and whether those reasons are consistent with the requirements for the exemption sought.

F. Review of Market Surveillance Investigations

Findings

- The Division reviewed all 10 MSD investigations that were open during any portion of the target period. Four of the 10 investigations related to position limit violations, one investigation related to failure to comply with the restrictions of a cash and carry exemption granted by the Exchange, one investigation related to large trader reporting deficiencies, two investigations related to open interest reporting deficiencies, one investigation related to a rule violation in connection with several Exchange of Options for Options transactions, and one investigation was suspended by the Exchange upon being separately investigated by the Commission's Division of Enforcement ("DOE"). The nine closed cases were variously resolved through Exchange warning letters and monetary fines, in the amount of \$20,000, \$25,000, \$50,000 and \$100,000.
- The Division believes that the analysis performed by MSD in the course of the 10 investigations was generally thorough, well-reasoned and sufficiently documented. The Exchange has recently implemented changes requiring that case numbers be assigned, and an investigation report be prepared, for matters that appear to involve an Exchange rule violation. The Division also understands that the Exchange has begun indicating the date on its investigation reports on which the report was approved by senior MSD staff,

in response to a recommendation made by the Division in a December 2012 rule enforcement review of the Exchange's disciplinary program. Finally, the Division believes that the sanctions imposed by the Exchange via warning letters and monetary fines appear generally reasonable relative to the violations alleged and evidence presented.

- The average length of time between the opening and closing of the nine closed investigations was 288 days. One of the nine closed investigations took 501 days to complete with no apparent mitigating circumstances justifying the prolonged open period, and another closed investigation involving extended negotiations took 652 days to complete.
- The Exchange informed the Division that the Market Surveillance Manager left the Exchange following the end of the target period. The Exchange also stated that, in an effort to reduce the time required to resolve surveillance investigations, the Exchange assigned the duties of the Market Surveillance Manager to the MSD Senior Analyst.

Recommendations

- The Division does not have any recommendations in this area.

III. PRODUCTS AND TRADING VOLUME DURING THE TARGET PERIOD⁵

Total trading volume at the Exchange during the period June 1, 2011 through June 30, 2012 was 119,637,373 contracts. The Exchange offered 109 different products for trading during this period, but four products alone accounted for approximately 77 percent of total volume: Russell 2000 Index futures (40 percent); Sugar No. 11 futures (24 percent); U.S. Dollar Index futures (7 percent); and Sugar No. 11 options (6 percent). Additional trading volume and product information is provided in Tables 1, 2 and 3, below.⁶

⁵ Data in this Section was obtained from the Exchange. Note that several statistics provided by the Exchange cover the period June 1, 2011 through June 30, 2012, while the target period covers a slightly different period (June 15, 2011 to June 15, 2012).

⁶ On October 15, 2012 (after the end of the target period), Intercontinental Exchange transitioned certain OTC energy swaps and options to futures and options. Following the transition, cleared North American natural gas, electrical power and physical environmental products are listed as futures and options on the Exchange, while cleared oil, freight, iron ore and natural gas liquids are listed as futures and options on ICE Futures Europe. Products transitioned to the Exchange are designated by the Exchange as ICE Futures Energy Division (IFED) products. See ICE Advisory memo, October 12, 2012, at https://www.theice.com/publicdocs/otc/advisory_notices/ICE_Advisory_10_12_003.pdf

Table 1 below lists the total Exchange volume during June 1, 2010 through June 30, 2011, and during June 1, 2011 through June 30, 2012. Exchange volume is subdivided by open outcry/pit volume, electronic trading volume, and off-exchange volume. The number of products traded increased from 99 to 109 (10 percent) over this two year period,⁷ but the Exchange experienced relatively modest volume growth (from a total volume of 117,013,652 to 119,637,373 contracts).

Table 1.

	Time period	Volume (in contracts)	Open Outcry Volume	Electronic Volume	Off Exchange Volume (EFP, EFS, EOO, Block)	No. of Products Traded
Futures	6-01-10 to 6-30-11	101,227,799	1,116,404	100,111,395	5,516,066	81
Futures	6-01-11 to 6-30-12	106,349,043	621,735	105,727,308	5,125,835	72
Options	6-01-10 to 6-30-11	15,785,853	14,159,548	1,626,305	876,127	18
Options	6-01-2011 to 6-30-12	13,288,330	7,312,116	5,976,214	1,191,908	37
Total	6-01-10 to 6-30-11	117,013,652	15,276,952	101,737,700	6,392,193	99
Total	6-01-11 to 6-30-12	119,637,373	7,933,851	111,703,522	6,317,743	109

⁷ In May 2012, the Exchange listed cash-settled grain futures and options contracts for corn, wheat, soybeans, soybean oil, and soybean meal. See https://www.theice.com/publicdocs/futures_us/exchange_notices/ExNot041212Grain.pdf

Table 2 below lists the names and total trading volumes for the Exchange’s five primary futures products (ranked by trading volume) during June 1, 2011 through June 30, 2012. Trading in the Russell 2000 Index, the Exchange’s most heavily traded futures product, represented approximately 40 percent of total Exchange volume during this period.⁸

Table 2.

Futures Product	Volume (in contracts)	Percentage of Total Exchange Volume⁹	Open Outcry Volume	Electronic Volume	Off Exchange Volume (EFP, EFS, EOO, Block)	Avg. Month-End Open Interest
Russell 2000 Index	47,966,206	40%	0	47,966,206	1,294,255	423,209
Sugar No. 11	28,408,728	24%	246,948	28,161,780	1,606,021	630,759
U.S. Dollar Index	8,419,843	7%	19,874	8,399,969	58,289	57,956
Coffee “C”	6,286,827	5%	77,233	6,209,594	322,124	124,921
Cotton No. 2	6,220,656	5%	151,565	6,069,091	434,835	162,218

⁸ The Exchange provided updated statistics that covered the period April 1, 2013 to April 30, 2014. The total Exchange volume during this period was 111,057,788 contracts. During this period, the Russell 2000 Index represented 30 percent of total Exchange volume (down from 40 percent in Table 2), and Sugar No. 11 represented 31 percent of total Exchange volume (up from 24 percent in Table 2). These were the most significant changes in the percentage composition of the individual products making up the total Exchange volume in futures products and in options products.

⁹ As indicated in Table 1, total Exchange volume during the period from June 1, 2011 through June 30, 2012 was 119,637,373 contracts.

Table 3 below lists the names and total trading volumes for the Exchange’s five primary options products (ranked by trading volume) during June 1, 2011 through June 30, 2012.¹⁰ Trading in Sugar No. 11, the Exchange’s most heavily traded options product, represented approximately 6 percent of total Exchange volume during this period.

Table 3.

Options Product	Volume (in contracts)	Percentage of Total Exchange Volume¹¹	Open Outcry Volume	Electronic Volume	Off Exchange Volume (EOO, Block)	Avg. Month-End Open Interest
Sugar No. 11	6,842,909	6%	3,719,253	3,123,656	720,738	608,958
Coffee “C”	2,760,609	2%	1,546,529	1,214,080	147,157	209,062
Cotton No. 2	2,722,449	2%	1,734,475	987,974	233,076	261,959
Cocoa	547,949	0.5%	100,352	447,597	79,550	72,467
FCOJ	189,292	0.2%	104,383	84,909	576	22,247

¹⁰ In October 2012, the Exchange ended floor trading for option contracts, and those contracts now trade exclusively on the Exchange’s electronic platform.

¹¹ As indicated in Table 1, total Exchange volume during the period from June 1, 2011 through June 30, 2012 was 119,637,373 contracts.

IV. EXCHANGE OVERVIEW

A. Ownership and Board of Directors

The Exchange is a wholly-owned subsidiary of Intercontinental Exchange, Inc. (the “ICE Parent”).¹² The ICE Parent is incorporated in the state of Delaware and listed on the NYSE. ICE Clear U.S. is the derivatives clearing organization of the Exchange, and clears all Exchange contracts. Although ICE Clear U.S. is a wholly-owned subsidiary of the Exchange, it maintains its own membership, board of directors, officers, and operating staff.

The Exchange is governed by its Board of Directors (the “Exchange Board”), the composition of which is governed by the Bylaws of the Exchange. The Bylaws are subject to modification by the Exchange Board and the stockholders of the Exchange in accordance with Article XVI of the Bylaws. The Exchange Board oversees the management of the Exchange’s business and its DCM self-regulatory obligations. Two individuals serve on the boards of both ICE Clear U.S. and the Exchange; the membership of the two boards does not otherwise overlap.

The Exchange Board consists of nine directors: (a) two individuals who are executive officers or directors of the ICE Parent; (b) the CEO or President of the Exchange; (c) four representatives who are not trading members and qualify as public directors; and (d) two other individuals elected by the shareholder of the Exchange.¹³ The Commission’s acceptable practices for DCM Core Principle 16 provide a safe harbor in the event that at least 35 percent of the board are public directors and other conditions are met (including that public directors meet qualification requirements set forth in the acceptable practices).¹⁴ The composition of the

¹² The ICE Parent operates multiple futures exchanges globally, including: ICE Futures U.S., ICE Futures Europe, ICE Futures Canada, NYSE Liffe US, LIFFE and ICE Singapore.

¹³ The Exchange has determined that the two directors elected by the shareholder of the Exchange also qualify as public directors.

¹⁴ As noted in the preamble to the DCM Core Principles rulemaking, “Acceptable practices are intended to assist DCMs by establishing non-exclusive safe harbors. The safe harbors apply only to compliance with specific aspects of the core principle, and do not protect the contract market with respect to charges of violations of other sections of the CEA or other aspects of the core principle.” 77 FR 36612 at 36614, note 13. The Acceptable Practices for Core Principle 16 of the CEA state that “Acceptable practices for minimizing conflicts of interest shall include the following elements: ... [a]t least thirty-five percent of the directors on a contract market’s board of directors shall be public directors.” *Id.* at 36720.

Exchange Board is consistent with these acceptable practices, as six out of nine of the members of the Exchange Board qualify as public directors (i.e., 67 percent).¹⁵

B. Regulatory Oversight Committee; Budget Matters

The Regulatory Oversight Committee (“ROC”) oversees all facets of the Exchange’s self-regulatory program, including trade practice and market surveillance, and the conduct of investigations. The ROC also reviews the size and allocation of the Exchange’s regulatory budget and resources, and the hiring, compensation, and termination of Exchange regulatory personnel. Finally, the ROC prepares an annual report assessing the Exchange’s self-regulatory program for the Exchange Board and the Commission, which sets forth the regulatory program’s expenses, describes its staffing and structure, and reviews the performance of the Exchange’s Business Conduct Committee. The composition and activities of the ROC are governed by Rule 3.40 of the Exchange Rulebook.

The ROC is comprised of the four directors who occupy the Board directorships designated in the Bylaws as the public director positions. No tie-breaking procedures are in place to resolve differences between the four members if a tie were to arise. The Division is concerned that with an even number of members and no tie-breaking procedures, the ROC may be unable to reach a decision in the event of a difference of opinion between ROC members. Accordingly, the Division recommends that:

- **The Exchange should implement tie-breaking procedures to resolve tie votes of the ROC, or alternatively, the Exchange should ensure that the committee is composed of an odd number of members greater than one.**

The members of the ROC do not have a fixed term, and there are no specific removal standards for its members. However, because the ROC is comprised of public directors serving on the Exchange Board, any such public director who ceases to be an Exchange Board director would automatically cease to be a ROC member.

As noted above, the ROC plays an integral role in setting the budget for the Market Regulation Department. The Market Surveillance budget is a subset of the larger Market

¹⁵ The six public directors are the four representatives who occupy the positions designated in the Bylaws as public directorships, and the two directors elected by the shareholder of the Exchange.

Regulation Department budget. Most of the Market Surveillance budget is dedicated to employee compensation. The Vice President of Market Regulation prepares the budget request in consultation with the General Counsel of the Exchange and the President of the Exchange. The Vice President then submits the budget request to the ROC. The ROC reviews the Market Regulation Department budget before it is submitted to the ICE Parent for approval. The Market Regulation Department received the budget requested during the target period, and has never been denied a budget that it requested.¹⁶ Once the Market Regulation Department budget is approved, it becomes part of the larger ICE Parent budget.

V. MARKET SURVEILLANCE DEPARTMENT STRUCTURE AND STAFFING

A. Organizational Structure

The Exchange's Market Regulation Department encompasses two sub-departments: the Market Surveillance Department and the Compliance Department. Interaction between the Market Surveillance Department and the Compliance Department occurs on a regular basis. Both the Market Surveillance and the Compliance Departments report to the Vice President of Market Regulation. The Vice President of Market Regulation reports to the Exchange's General Counsel.

The Market Surveillance Department principally relies upon two external departments for information critical to its function. First, the Exchange's Commodity Operations Department oversees deliveries and collects information with respect to delivery notices issued and stopped. The Market Surveillance Department utilizes this information during expiration periods. Second, ICE Clear U.S., the derivatives clearing organization for the Exchange, provides volume data and customer and house open interest data utilized by Market Surveillance, as discussed in Section VII(A)-(B) below. MSD also consults with Control Committees, as discussed in the following section.

¹⁶ The 2012 budget (which corresponds to the calendar year) for the Market Regulation Department was \$3,439,881. As a comparison, the 2011 budget for the Market Regulation Department was \$3,474,119. Variances in the budget from one year to the next are typically related to changes in staffing. The Market Regulation Department also receives other types of support (e.g., technology and human resources) that are not included in the Market Regulation budget, but are instead budgeted on an Exchange-wide basis.

B. Control Committees

The Market Surveillance Department relies upon “Control Committees” for guidance on market surveillance issues. Control Committees are established by the Exchange, and each Committee consists of three Exchange members. There is a Control Committee for each Exchange-listed product. MSD selects the three members for each product-specific Control Committee from a larger pool of Exchange members that have offered to serve on Control Committees. Members cannot serve on a Control Committee for a product that they actively trade. For example, an individual who trades coffee could serve on the Cocoa Control Committee, but could not serve on the Coffee Control Committee.

As an example of the Exchange’s use of Control Committees, if the Exchange receives a number of position limit exemption requests when a contract with tight supplies is about to expire, MSD may ask the applicable Control Committee for a recommendation as to how to handle the requests. In addition, MSD may consult the Control Committees when events occur that could result in a disorderly liquidation, including price distortions or market disruptions.¹⁷ Exchange officials explained to the Division that recommendations made by Control Committees are typically respected by MPs. As a result, Exchange representatives believe that MSD’s recommendations on a particular issue are better accepted by MPs if MSD has previously consulted with the relevant Control Committee. The Control Committees do not have the authority to make final decisions. When Division staff first interviewed Exchange representatives in connection with this rule enforcement review, the representatives stated that MSD generally takes the advice of the Control Committees. The Exchange representatives later clarified that MSD typically brings a proposal to the Control Committee, and the Committee typically agrees with the MSD proposal. During the target period, the Control Committee met twice in June 2011 to discuss the July 2011 Cotton expiration. The Control Committee did not meet at any other time during the target period.

The Division would be concerned if MSD is taking direction from the Control Committee regarding exemptions or the other issues discussed above, rather than treating the

¹⁷ See the discussion of the Control Committee’s role in monitoring for price convergence in Section VIII(B) below.

Control Committee solely as a consultative body. In the view of the Division, members of the Control Committee might be more likely to support conduct in which they themselves engage, even if that conduct is not consistent with the overall quality of the market.

The Division did not identify a failure with respect to the Exchange's use of Control Committees, and did not identify any situation in which the Control Committee determined the outcome of an issue on which it was consulted by MSD. Nonetheless, as a general principle, the Division emphasizes that the Control Committee should not exercise determinative authority. The Division reminds the Exchange that while it may be helpful for MSD to consult with the Control Committee on the issues discussed above, MSD should retain ultimate authority to make determinations on such issues, irrespective of the views of the Control Committee.

C. Staffing and Personnel

As noted above, the Market Surveillance Department is a subset of the Market Regulation Department. MSD consisted of eight personnel at the end of the target period, out of 23 personnel overall in the Market Regulation Department. There have not been significant changes in staffing in the Market Surveillance Department since the 2005 Market Surveillance RER (which reviewed the Exchange's predecessor NYBOT). At that time, there were also a total of eight fully-dedicated personnel, although the roles and responsibilities of certain personnel have changed in the interim.¹⁸ Market Surveillance is led by a highly experienced Vice President of Market Regulation ("Vice President"),¹⁹ who also leads the Exchange's Compliance Department

¹⁸ See also note 6 above. After the end of the target period, Intercontinental Exchange transitioned certain OTC energy swaps and options to futures and options. Following the transition, cleared North American natural gas, electrical power and physical environmental products are listed as futures and options on the ICE Futures U.S. Products transitioned to the Exchange are designated by the Exchange as ICE Futures Energy Division (IFED) products. Staff responsible for the surveillance of these products when they were traded OTC continues to survey them as IFED products. A total of nine staff members survey IFED products.

¹⁹ The Vice President joined the Exchange's staff in September 2005. His 27 years of experience in futures compliance include 20 years with New York futures exchanges (COMEX, NYMEX, ICE/NYBOT) and seven years with various FCMs.

and consults directly with the ROC. During the target period, the following seven individuals in the Market Surveillance Department reported to the Vice President of Market Regulation:²⁰

- (1) The Managing Director,²¹ whose duties include managing routine market surveillance activities and exemption requests for Coffee, Sugar, and Cocoa.
- (2) The Market Surveillance Manager,²² whose duties include managing all exemption requests except for Coffee, Sugar, Cocoa, and cash-settled grains, in addition to routine market surveillance activities.
- (3) The Senior Analyst,²³ whose duties include supporting the Managing Director and the Market Surveillance Manager, as well as managing exemption requests for cash-settled grains.
- (4) The Database Analyst,²⁴ who performs routine market surveillance activities.
- (5) The Exchange of Futures for Physicals (“EFP”)/Operations Manager,²⁵ whose duties include producing the monthly EFP Review and weekly Spec Hedge Reports, along with monitoring and calculating contract dates.
- (6) The EFP/Operations Assistant, whose duties include assisting the EFP/Operations Manager.
- (7) The Surveillance Assistant, whose duties include producing the margin information released by the Exchange.

²⁰ Following the end of the target period, one of the two administrative assistants ceased working at the Exchange after the individual’s role was electronically automated.

²¹ The Managing Director has 17 years of market surveillance experience and an additional seven years of commodities research experience. The median tenure (in years) of experience for Market Surveillance Department staff is 22 years.

²² The Market Surveillance Manager has more than 38 years of market surveillance and compliance experience, which includes 34 years at the Exchange and several years at the CFTC and its predecessor.

²³ The Senior Analyst joined the Exchange in May 2012. The Senior Analyst has 13 years of commodities industry experience and is being trained in all aspects of market surveillance.

²⁴ The Database Analyst joined the Exchange in February 2012 and is being trained in investigations and other aspects of market surveillance.

²⁵ The EFP/Operations Manager has over 13 years of experience with EFP reviews and has worked at the Exchange for a total of 24 years in research and economics functions.

The Managing Director, Market Surveillance Manager, and EFP/Operations Manager supervised the other members of the Market Surveillance staff during the target period. Additionally, a member of the Compliance Department who specializes in information technology is available to MSD if issues arise that require technical skills (e.g., generating automated reports).

In January 2013, following the end of the target period, the Exchange transferred responsibility for reviewing Exchange for Related Positions (“EFRP”) transactions from Market Surveillance to the Exchange’s Trade Practice Compliance group. The transfer was intended to enable the Trade Practice Compliance group to leverage its specialized investigatory and analytical experience when reviewing EFRPs, allowing Market Surveillance staff to focus on its core responsibilities.²⁶ The Exchange also revised and expanded its EFRP, block trade, and money pass review processes, and upgraded its surveillance reports to improve the Exchange’s ability to target high-risk EFRPs and block trades for closer review. Finally, the Exchange began providing enhanced training to MSD staff with respect to EFRPs and block trades, and filed documents with the Commission notifying MPs of the Exchange’s EFRP procedures.

While the Division believes that MSD personnel are qualified and experienced, the Division is concerned about the potential impact of staffing changes in connection with efforts to reduce the time required to resolve surveillance investigations. As discussed in more detail in Section X(B) below, four of the nine closed investigations took over one year to complete: 424 days, 450 days, 501 days and 652 days. The Exchange informed the Division that the Market Surveillance Manager left the Exchange following the end of the target period. The Exchange also stated that, in an effort to reduce the time required to resolve surveillance investigations, the Exchange assigned the duties of the Market Surveillance Manager to the MSD Senior Analyst, who was being previously trained by MSD to take over these duties prior to the personnel change. In light of this reduction in staffing and personnel change within MSD, the Division recommends the following:

²⁶ The EFP/Operations Manager remained in MSD following this reorganization, and was assigned additional operational responsibilities related to market surveillance. The reorganization did not result in any changes to the staffing of MSD, or any other changes to the responsibilities assigned to members of MSD.

- **The Exchange should ensure that MSD maintains staffing sufficient to perform all of its surveillance responsibilities, including timely completion of surveillance investigations.**

VI. MARKET SURVEILLANCE PROCEDURES AND SYSTEMS

A. Market Surveillance Procedures Manual

Pursuant to the Exchange's Procedures Manual, MSD performs the following significant responsibilities on a routine basis, in addition to other specific duties discussed in more detail below:

- Monitor large trader positions through the Exchange's computerized large trader reporting system, in order to detect potential position limit violations, positions in excess of position accountability levels, potential reporting deficiencies, and deviations from MPs' normal trading activity.
- Monitor daily trading in Exchange contracts using MSD's trading surveillance application (SMARTS), to identify deviations from participants' normal trading activity.
- On a daily basis, monitor Exchange-generated reports that compare large trader data to open interest, for purposes of identifying reporting discrepancies and ensuring the accuracy of large trader data.
- On a daily basis, analyze price and volume data to detect (e.g.) unusual price movements, market congestion, or unusual volume activity, which could be indicative of underlying problems in the market.
- Contact trade sources and large traders on a regular basis to monitor deliverable supplies of physical-delivery commodities, as well as delivery intentions when a contract is approaching or is in a notice period, in order to ensure an orderly liquidation.
- Intensify surveillance during contract expirations, in order to detect and prevent price manipulation and facilitate orderly liquidations. MSD focuses on large trader positions and position concentrations, and the relationship between open interest and deliverable supplies.

- Determine appropriate responses to potential rule violations, including position limit violations, reporting violations, and failure to provide 102 forms.²⁷ Responses may include an information letter or warning letter, further investigation, or referral to the Compliance Department or to the Clearinghouse for summary action.

B. Large Trader Reporting System

MSD's principal tool for monitoring positions held by large traders is the Market Surveillance Application ("MSA"), the Exchange's computerized large trader reporting system.²⁸ MSD reviews large trader positions through the MSA in order to detect potential position limit violations, positions in excess of position accountability levels, potential reporting deficiencies, and deviations from MPs' normal trading activity.²⁹ The MSA maintains large trader data on futures and options positions received from clearing members and other reporting firms. All clearing members are required to transmit reportable futures and options position data daily to the Exchange.³⁰ Once an MP reaches the reportable level in one contract, then the MP must report all of its positions in that particular commodity to the Exchange. Non-member FCMs and foreign brokers are also required to provide daily large trader reports (including reportable futures and options positions) to the Exchange. The MSA also maintains historical large trader information.

MSD uses the database information available in the MSA to generate a variety of reports, including a report organized by reporting firm that lists all unidentified accounts. When an unidentified account holds a large position, MSD contacts the relevant firm by telephone and

²⁷ See the Commission website for more information regarding 102 forms at <http://www.cftc.gov/ucm/groups/public/@forms/documents/file/cftcform102.pdf>

²⁸ The Exchange transitioned to the MSA system in January 2007.

²⁹ See Section IX below for additional information on position limits and accountability levels.

³⁰ Exchange Rule 6.15(a) requires that "Members which own, control, or carry for any Customer a reportable position, as such term is defined by the Act and the Regulations thereunder, shall submit daily reports with respect to such positions to the Exchange containing such information as may be prescribed by the CFTC." See § 15.00(p) of the Commission's regulations for definition of "reportable position."

requires the firm to submit a 102 form, in order to expedite the identification process. MSD gives clearing members, non-clearing FCMs, and foreign brokers five business days to submit the 102 form. MSD makes requests for 102 forms on a weekly basis, or more frequently as needed.

The MSA stores account identification data, data on delivery notices that MPs have issued and stopped, and Against Actuals (“AA”)/EFP transactions for MPs with reportable positions. MSD uses the MSA application to aggregate related and/or commonly controlled accounts, based on information obtained from 102 forms and MSD discussions with reportable MPs. MSD may view positions within the application by account, MP, commodity, or on an aggregate basis.

C. Electronic Tools for Monitoring Trading

1. **SMARTS.** The Market Surveillance Department complements the MSA with SMARTS, a third-party trade surveillance application. The SMARTS application provides MSD with the capability to monitor and review trading in a graphical format. SMARTS also allows MSD to view details of trades, as well as details of executed and unexecuted orders, on a real-time basis. MSD may view trading activity in a specified market for an entire day, or for a specified time period or point in time during the day. MSD conducts intensive monitoring using SMARTS during contract expirations and delivery periods.

MSD uses four specific tools available through SMARTS:

- (1) The ‘spread’ tool generates a graphical view of trading in a particular market;
- (2) The ‘broker overview’ tool allows MSD to monitor the order book activity (including filled, unfilled and canceled orders) of a specific MP;
- (3) The ‘replay’ tool recreates the order book and market depth at any point in time; and
- (4) The ‘ALMAS’ tool generates automated, real-time market alerts (e.g., alerts regarding a particular MP, or volume in a particular account).

MSD uses SMARTS to generate two alerts specifically for market surveillance purposes: a Price Spike Alert and Participant Volume Spike Alert. The Price Spike Alert is designed to identify potential improper trading activity by an MP that may represent an attempt to

manipulate price or direction of the market. The Participant Volume Spike Alert is designed to detect aberrant or unusual trading by an MP that may be indicative of improper trading activity.

Each of the four SMARTS tools described above allows the user to view trading activity in real time in a particular market at the market level or MP level. Because SMARTS also maintains historical information, it allows MSD to use the above-described tools to reconstruct the order book and trading, or replay trading activity in a market for trade dates prior to the current day.

2. **WebICE.** In addition to SMARTS, the Exchange uses its internal webICE application on a daily basis to monitor trading activity. WebICE displays real-time price and volume data. MSD uses webICE to generate an overview of trading activity, and uses SMARTS to review trading activity on a more granular basis and to identify specific MPs holding positions.

D. Crystal Reports; ICE Report Center

1. **Crystal Reports.** MSD generates a number of reports through the Exchange's "Crystal" application for purposes of monitoring market fundamentals. The Crystal application creates reports using data stored in the Exchange's database. None of the Crystal reports are automated; instead, they must be run manually by MSD. MSD may download information from the Crystal reports into an Excel spreadsheet so that the data may be further sorted. Several of the Crystal reports that are most fundamental to MSD's market surveillance activities are discussed below.

a. **Firm Positions vs. Open Interest (OI) Spreadsheet.** The Firm Positions vs. Open Interest (OI) Spreadsheet (the "Firm Positions Spreadsheet") compares a clearing member's large trader data to its open interest to identify reporting discrepancies. MSD addresses such reporting discrepancies by contacting clearing members and other reporting firms to determine the reason(s) for the discrepancies so that large trader and open interest data is reported accurately. Open interest data is made available in several different reports in the Report Center on the ICE website (discussed below).³¹ Prior to the introduction of the Firm

³¹ See, e.g., the ICE Futures U.S. Daily Volume and OI Summary for Futures, at <https://www.theice.com/marketdata/reports/ReportCenter.shtml#report/37>.

Positions Spreadsheet, MSD reviewed the Positions vs. OI Futures Spreadsheet to compare a clearing member's large trader data to its open interest. The Firm Positions Spreadsheet offers a more detailed view than the Positions vs. OI Futures Spreadsheet because the Firm Positions Spreadsheet breaks large trader positions into two categories: trader and omnibus accounts. Large trader data that appears in the Firm Positions Spreadsheet is provided by clearing firms and other reporting firms, while open interest data is provided by the Clearinghouse. When generating the Firm Positions Spreadsheet, MSD sets a variety of parameters: date, futures and/or options, commodity or all, firm ID (the code for a clearing member) or all, percentage difference, and minimum OI. MSD monitors the Firm Positions Spreadsheet closely near contract expiration in order to ensure the accuracy of open interest and large trader reporting, but monitors the Spreadsheet less frequently at other times.

b. *OI vs. Position Alert Report and EFP and Notices Report.* On a daily basis, MSD reviews the OI vs. Position Alert Report, a Crystal report that identifies significant discrepancies between reported large trader positions and open interest. The OI vs. Position Alert Report was introduced in September 2013, following the end of the target period. In its review of MSD's surveillance capabilities, the Division was concerned about MSD's ability during the target period to monitor for open interest on a consistent basis throughout the contract lifecycle. The Division believes that the introduction of the OI vs. Position Alert Report following the end of the target period, and the daily review of this report by MSD, should address this concern. The report allows MSD to identify discrepancies that equal or exceed a percentage (set by the user) for contracts with an amount of open interest that equals or exceeds a certain quantity (also set by the user). MSD also generates the EFP and Notices Crystal report to review reports of large traders' EFRPs and deliveries. This data assists MSD in reviewing market activity of large traders and in monitoring contract expirations. This report assists MSD to anticipate MPs' behavior in the current expiration. For example, MSD analyzes the historical behavior of MPs in the market to determine how frequently they made or took delivery in past expirations. This information promotes an orderly liquidation, by improving MSD's ability to forecast whether MPs are capable of making or taking delivery.

c. *Top Day Alert Report, Over Limits Alert Report and Trader Positions Over Time Spreadsheet.* On a daily basis, MSD also reviews large trader positions for

compliance with speculative position limits and/or position limits granted by exemptions.³² MPs that are near or above their position limits are identified in two Crystal reports: the Top Day Alert Report and the Over Limits Alert Report. The Top Day Alert Report displays alerts for the most recent trading day. The report shows the name and position of any entity that has a position in excess of a specific position quantity or percentage of a speculative position limit that has been established by MSD. The Over Limits Alert Report provides a more granular view of information presented in summary fashion in the Top Day Alert Report. The Over Limits Alert Report shows both the gross and net positions of any entity that has a position exceeding a specified limit, and allows users to view positions on both an aggregate and disaggregated basis, broken up by MP. On an as-needed basis, MSD reviews the Trader Positions Over Time Spreadsheet, a Crystal report that provides historical large trader position information over a date range selected by the user. MSD uses this spreadsheet most often during the period leading up to the date when a spot month position limit takes effect. MSD uses the spreadsheet to monitor changes in positions as those dates approach.

2. ICE Report Center. The Exchange makes a variety of reports available via the Report Center on the ICE website, which is a publicly available website.³³ These reports, which are generated from Exchange and Clearinghouse data, include a Daily Volume and Open Interest report, Historical Monthly Volume report, End of Day report, Delivery Notice report, and Daily Settlements report, among others. The Report Center allows users to generate reports for specific markets and date ranges. MSD reviews these reports on a regular basis in connection with its market surveillance activities.

E. Data Regarding Deliverable Warehouse Receipts

On an as-needed basis, MSD asks the Exchange's Commodity Operations Department whether certain MPs hold deliverable warehouse receipts. This information is not available to MSD through an automated system. Deliverable warehouse receipts give MPs the right to draw

³² See Section IX below for a discussion of monitoring procedures for position limits and accountability levels.

³³ <https://www.theice.com/marketdata/reports/ReportCenter.shtml>

down exchange-grade products from a warehouse. By determining whether MPs hold deliverable warehouse receipts, MSD is better able to determine whether these MPs can make delivery in the current expiration.

F. Conclusions Regarding Reporting Systems and Other Automated Tools

The Division believes that the Exchange has appropriate tools for monitoring daily trading activity and positions held by large traders, in addition to other daily market surveillance tasks. The Division therefore has no recommendations in this area. At the same time, the Division believes that the Exchange should continue to evaluate whether its reporting systems and other tools (including, for example, the MSA, SMARTS, Crystal reports, and the reports available on the ICE Report Center) can be further improved to function in more automated and efficient ways. For example, the Exchange should consider whether to eliminate the need for manually downloading information into Excel spreadsheets prior to its routine use by MSD. The Exchange should also consider whether to incorporate additional functionality or new search criteria, improve the processing time required for systems to generate reports, or add new reports to enable MSD to evaluate market surveillance data more efficiently and effectively.

VII. ROUTINE SURVEILLANCE OF MARKET FUNDAMENTALS

A. Monitoring For Open Interest

As mentioned above, MSD reviews the Firm Positions Spreadsheet frequently, and the OI vs Positions Alert Spreadsheet daily, to monitor for open interest and large trader reporting discrepancies. MSD generates the Firm Positions Spreadsheet daily for contracts during notice period to determine where non-reportable positions are cleared. When reviewing the reports, MSD looks for situations where reported open interest is significantly larger or smaller than large trader positions, indicating possible errors in large trader reporting or open interest reporting. Mistakes in open interest reporting may occur when positions are closed out in omnibus accounts, but the carrying firm does not inform their clearing firms that those positions are closed out. In this scenario, the omnibus positions continue to be erroneously reported in open interest. Open interest reporting errors can also occur when large EFPs are cleared into a customer account but should be cleared into a firm's house account, and when futures positions

that result from option expirations are not correctly applied to existing futures positions. Instances of misreporting of open interest during the target period are discussed below and in Section X(B).

On a daily basis, MSD also reviews open interest reporting on the End of Day Reports (such as the Daily Market Report), via the Report Center on the ICE website. If a report shows a change in open interest that is larger than trade volume (or trade volume plus notices during notice period), MSD will generally conduct further investigation, since this would indicate a possible misreporting of open positions by one or more MPs.

The Division has identified a number of issues related to the misreporting of open interest. While the Clearinghouse Rulebook does have rules stating that open interest must be reported correctly, there is no Exchange rule that sets forth procedures regarding open interest reporting. As a result, the Exchange does not have specific protocols in place that establish when it will address misreporting of open interest in addition to or in lieu of the Clearinghouse. For example, the Exchange has not established written rules or procedures clarifying whether the Exchange or Clearinghouse is responsible for conducting investigations, preparing and issuing fines, and bringing disciplinary cases for misreports of open interest. During the target period, both the Exchange and Clearinghouse brought sanctions for instances of misreporting of open interest, raising questions about which entity is responsible for investigating and sanctioning such misreporting. (During the target period, the Clearinghouse issued five fines of \$500 each for open interest misreporting, and one fine for \$1,000. The Division questions whether fines of \$500 are sufficient to deter recidivism by member firms.) Furthermore, while the Exchange maintains copies of Clearinghouse assessment letters addressing instances of misreporting, the Exchange does not always assign a case number when investigating instances of misreporting, and does not track on a log investigations that do not receive a case number. The Exchange did assign case numbers to two instances of misreporting of open interest during the target period, as discussed below and in Section X(B).

In case # 2012-033, a firm misreported open interest when it reported a large amount of open interest, but a much smaller number of large trader positions. (The same firm had also misreported open interest during another recent expiration.) Case # 2012-033 was resolved after the Exchange issued a warning letter to the firm, and the Clearinghouse issued an assessment letter, involving a \$1,000 fine, for the same misreporting event.

Case # 2012-002 involved open interest misreporting by a firm on December 13, 2011. The Exchange opened an investigation on January 3, 2012. A 21 day lapse therefore occurred in this instance between the misreported open interest and investigatory action being taken by the Exchange. Case # 2012-002 was ultimately resolved in April 2013, when the firm paid a fine of \$20,000 pursuant to a settlement agreement with the Exchange.

The Division makes the following recommendations to ensure that the Exchange implements clear and systematic rules or procedures and appropriate sanctions regarding the misreporting of open interest:

- **If the Exchange intends to continue to sanction misreporting of open interest alongside the Clearinghouse, then the Exchange’s rulebook should set forth specific rules stating that open interest misreporting represents a violation of Exchange rules. Any Exchange sanctions for the misreporting of open interest should be sufficient to deter recidivism.**
- **The role of Exchange staff in enforcing Clearinghouse requirements regarding open interest reporting should be formalized in the procedures manual of the Exchange. If the Exchange intends to continue sanctioning misreporting of open interest, it should maintain records of any sanctions also issued by the Clearinghouse so that it may properly account for recidivist behavior.**

B. Monitoring For Prices and Volume

MSD uses a number of resources to analyze price and volume data in order to detect, for example, unusual price movements, potential price distortions or manipulation, market congestion, or unusual volume activity, which could be indicative of underlying problems in the market. MSD also analyzes such data to ensure that information provided in various reports in the Report Center on the ICE website is accurate.

1. **Price Data.** For purposes of acquiring market news, cash price changes, and other price relationships relevant for market surveillance purposes, MSD analysts scan various independent market news websites and commodity-oriented websites, such as Agrimoney. MSD does not, however, have access to any private wire services. MSD also reviews SMARTS and the Exchange’s webICE application on a daily basis for real-time trade

data, including price quotes. Finally, MSD speaks to MPs on a regular basis to obtain information about prices in both the futures markets and related cash markets.

2. Volume Data. MSD also reviews SMARTS and the webICE application on a daily basis for volume information. In addition, MSD analyzes volume data received from the Clearinghouse. Volume data is made available in several different reports in the Report Center on the ICE website.³⁴

The Division believes that private newswire services can enable analysts to perform more effective market surveillance. Such services can be used to identify problems developing in the marketplace, find new sources of information, identify MPs' strategies and activities in the market, and locate historical data on prices and volume, in addition to other uses relevant to market surveillance. The Exchange's Procedures Manual states that analysts should "use the internet, wire services and Exchange data" to monitor prices, trading and volume daily in Exchange contracts. MSD analysts do not, however, have access to private wire services.

Accordingly, the Division suggests that the Exchange enhance its market surveillance program by providing private commodity-oriented newswire services to its analysts, either on their desktops, or in a stand-alone device near their work areas. Examples of available services include FutureSource, Reuters, or Bloomberg.

C. Monitoring Deliverable Supply for Physically Delivered Commodities

MSD monitors deliverable supply to avoid situations in which there is insufficient supply of a commodity at expiration, which can make the commodity contract susceptible to price manipulation or distortion. In connection with this monitoring process, MSD routinely contacts MPs to inquire about deliverable supply in relation to upcoming contract expirations. MSD also consults warehouse stock reports to monitor for deliverable supply. MSD reviews warehouse stock reports daily during the period leading up to notice periods and during notice periods, and frequently at other times. MSD also consults with the Commodity Operations Department staff to obtain additional information about warehouse stocks, such as the identification of owners of such stocks.

³⁴ See, e.g., the ICE Futures U.S. Daily Volume and OI Summary for Futures, at <https://www.theice.com/marketdata/reports/ReportCenter.shtml#report/37>.

In addition to the warehouse stock reports, MSD monitors market news daily for information that could impact deliverable supplies, such as weather disturbances or strikes at origin or delivery points. To analyze supply and demand data and other relevant market information, MSD reviews USDA reports, such as World Markets and Trade for all soft and agricultural commodities, World Agricultural Production for cotton and grains, and the Weekly Cotton Market Review. MSD reviews reports from domestic and foreign agencies and institutions, such as the Florida Agricultural Statistics for orange juice, the Brazilian government agency Conab for Brazilian sugar production, and the Australian government agency ABARES for cotton statistics. Finally, MSD reviews reports by FCM analysts and foreign brokers, such as Softs: Fast Facts for soft commodities, which is available on the public Exchange website.³⁵

When monitoring deliverable supply, MSD conducts further investigation in a variety of circumstances, such as: (a) if the warehouse stock reports indicated low stocks or large drawdowns of stocks; (b) if the reports indicated small or no quantities put up for grading, or unusually large quantities put up for grading; or (c) if MSD detected a concentration of ownership, particularly if an entity requested a long exemption from position limits, but already owned a significant portion of existing certified stocks.

The Division believes that the Exchange has adequate procedures for monitoring deliverable supply of physical-delivery contracts and its adequacy to satisfy the delivery requirements. Accordingly, the Division has no recommendations in this area.

VIII. SURVEILLANCE OF EXPIRING CONTRACTS

A. Standard Procedures for Intensified Surveillance

MSD conducts intensified surveillance of expiring contracts in order to detect and prevent price manipulation and facilitate orderly liquidations. Intensified surveillance typically begins approximately two weeks prior to a spot month and continues throughout this period. MSD focuses on large trader positions and position concentrations, and the relationship between deliverable supply and open interest. For example, MSD conducts daily review of the trading

³⁵ See https://www.theice.com/publicdocs/futures_us/ICE_Monthly_Softs_Fast_Facts.pdf

and positions of large traders, in light of current open interest and the size and ownership of deliverable supply for physical delivery contracts. MSD also monitors cash market prices, unusual short supply indications, abnormal price relationships among cash, futures, and options markets, and other unusual market circumstances that could potentially result in liquidation problems. MSD relies principally on the SMARTS system to conduct intensified surveillance of expiring contracts. MSD also reviews charts comparing open interest over the prior three years to determine if open interest is large or small in the current expiration as compared to historical trends.

Two weeks before the notice period and spot month position limits take effect, MSD sends reminder letters to MPs whose current positions would violate those limits, and who might be eligible for an exemption. Applicants must submit exemption requests at least five business days before the date on which applicants are requesting that the exemptions become effective.³⁶

MSD also schedules Control Committee meetings on an as-needed basis for the week before notice period or spot month position limits take effect.³⁷ If warranted by market conditions, additional Control Committee meetings may be scheduled during the notice period or last trading month.

The Division has determined that the Exchange has an adequate standard procedure for intensified surveillance of expiring contracts to detect and prevent price manipulations and facilitate orderly liquidations. Accordingly, the Division has no recommendations regarding this procedure.

B. Monitoring for Price Convergence

As part of its standard procedures for intensified surveillance, MSD also monitors for price convergence. Price convergence refers to the process whereby the price of a physically delivered futures contract converges to the spot price of the underlying commodity, as the futures contract nears expiration. The effectiveness of a physically delivered contract as a hedging instrument is determined, in part, by the extent to which the futures price reliably converges to

³⁶ See Section IX below for a detailed discussion of MSD's procedures for monitoring of position limits and accountability levels.

³⁷ See Section V(B) above for a discussion of the structure and role of Control Committees.

the comparable cash market price, or to a predictable differential to the comparable cash market price.³⁸ Commission regulation 38.252(a), the compliance date of which occurred following the end of the target period, requires that, for physical-delivery contracts, a DCM must demonstrate that it “monitors a contract’s terms and conditions as they relate to the underlying commodity market and to the convergence between the contract price and the price of the underlying commodity and show a good-faith effort to resolve conditions that are interfering with convergence.”³⁹

MSD asserts that it has limited ability to monitor for price convergence in the international soft products (*i.e.*, Coffee, Sugar and Cocoa). According to MSD, it is inherently more difficult to statistically determine convergence of futures to cash market prices for international soft products. MSD cited the example of the ICE Futures U.S. Sugar No. 11 contract; the cash price of sugar of deliverable quality can be different in different geographic locations, and there is no available resource that reflects the cash price at each/any of these locations at a given point in time. As a result of this characteristic of international soft commodities, MSD noted that convergence does not carry the same connotation as it might in the case of domestic agricultural commodities for which daily prices are published by government agencies and other public sources. MSD also noted that it regularly receives input from the members of the Exchange’s Coffee, Sugar and Cocoa product advisory committees. In addition, MSD stated that it contacts trade sources and large traders on a regular basis to collect information regarding physical market developments and discuss price movements and physical supplies. Finally, MSD noted that it works closely with Control Committees in monitoring the expiration of futures contracts, particularly when a situation is identified that could result in a disorderly liquidation, including price distortions or market disruptions.

The Division is continuing to review the Exchange’s procedures with regard to monitoring for price convergence in the international soft products to determine if they are

³⁸ See 75 FR 80572, Dec. 22, 2010 at 80583 for a discussion of the price convergence process.

³⁹ The compliance date of Commission regulation 38.252(a) was October 17, 2012, following the end of the target period.

consistent with Commission regulation 38.252(a).⁴⁰ As a result, the Division is not making any determinations in this rule enforcement review with respect to the Exchange's procedures for monitoring for price convergence in the international softs products.

C. Expirations During the Target Period Requiring Intensified Surveillance

The Exchange has developed written criteria to determine whether a contract expiration is or could become problematic. For example, for physical delivery contracts, the Exchange considers several factors, including whether any of the following have occurred: (1) there are tight supplies for the delivery period; (2) dominant positions are held by a single MP on either the long or short side; (3) long positions are held by MPs that want to take delivery that exceed available deliverable supplies; (4) large short positions are held by entities without the capacity to make delivery; (5) and/or short positions are held that exceed the likely demand for delivery.

The Exchange identified one contract expiration that required particular scrutiny during the target period: the July 2011 Cotton futures contract, which was subject to tight supplies. In addition, an entity with a large short position did not appear to have the capacity to deliver. In examining this expiration, the Division found that this expiration file contained adequate documentation, including notes regarding MSD's discussion with the relevant Control Committee, and notes regarding a June 2011 discussion with Commission staff with respect to this expiration. The contract expiration culminated in an orderly fashion.

The Division has determined that the Exchange has adequate procedures for identifying and analyzing contract expirations that are or could become problematic in order to facilitate orderly liquidations. For the one expiration requiring intensified scrutiny during the target period, MSD responded appropriately to the expiration-specific market factors, ensured orderliness, and kept well-documented files. Accordingly, the Division has no recommendations regarding this procedure.

⁴⁰ In the event that the Division determines that the Exchange's procedures with regard to monitoring for price convergence in the international soft products may be inconsistent with Commission regulation 38.252(a), the Division will contact the Exchange to address this issue.

IX. POSITION LIMITS AND ACCOUNTABILITY LEVELS

A. Monitoring of Position Limits and Accountability Levels

1. *Overview.* The size of Exchange MPs' positions is subject to two types of monitoring and control: position limits and position accountability levels. The Exchange sets position limits and accountability levels for all Exchange-traded products, subject to Commission approval, with two exceptions: the position limits for Cotton No. 2 and cash-settled grain contracts, which are stipulated by Commission regulations.

Position limits are set by the Exchange when a product is first launched and may be adjusted periodically. Exemptions may be granted for single month and net overall month limits, and the notice period and spot month period for the Sugar No. 11 contract. Position limits bar an MP from holding or controlling a net futures equivalent position that exceeds the position limit for the contract in question. The particular position limit may be adjusted in individual instances by a hedge, arbitrage or straddle exemption granted to the participant by the Exchange, as discussed below. Exceeding a position limit without having previously obtained an exemption is a rule violation, unless the MP exceeded the limit due to unforeseen bona fide hedging needs, and files for an exemption within a specified period after the position is assumed.

Position accountability levels are also set by the Exchange when a product is first launched, and are based on MSD assessment of available data, such as deliverable supply information and projected open interest. Accountability levels can be adjusted periodically, and adjustments thereto constitute rule filings that are subject to approval by the Commission or the Commission's self-certification procedures.⁴¹ Position accountability rules enable the Exchange to instruct an MP not to increase its position any further and/or to reduce its position to the appropriate accountability level. The Exchange may invoke this authority due to liquidity concerns, or for any other reason that the Exchange believes may negatively impact the market. Position accountability levels apply to single month and net all month positions in Cocoa, Coffee, Sugar No. 11 and certain currencies.

⁴¹ CEA § 5c(c); 17 C.F.R. §§ 40.5, 40.6.

2. *Monitoring of Position Limits.* On a daily basis, MSD reviews large trader positions for compliance with speculative position limits. MPs that are near or above their position limits are identified in the Top Day Alert Report and the Over Limits Alert Report. MSD may set alerts in the Top Day Alert Report at a specific contract level, or at a percentage of the position limit. Position limit alerts are typically set at 80 percent of the applicable limit (or 80 percent of a limit as modified by a position limit exemption).

The Over Limits Alert Report provides a more granular view of information presented in summary fashion in the Top Day Alert Report. MSD views each report daily. MSD also uses the Commodity screen in MSA to monitor for compliance with position limits. This screen allows MSD to view all positions in a commodity for a specific contract month or in all months combined, sorted by size of position. MSD can choose to view only positions in excess of a certain quantity through the MSA in order to focus on large positions.

MSD may telephone, e-mail, or fax an advisory letter to identified MPs notifying them that they are approaching their position limit, asking about their trading strategy and intentions, and reminding them that they may need to apply for an exemption or an expansion of a current exemption, if appropriate.

If an MP exceeds a position limit, then MSD attempts to contact the MP by telephone or e-mail. If the MP has exceeded the limit due to unforeseen bona fide hedging needs, then the MP is permitted to file an exemption request. MPs are allowed five business days to file an exemption request for Coffee, Sugar and Cocoa, and 10 business days for all other contracts. If MSD approves the exemption, then no violation is deemed to have occurred.

3. *Monitoring of Position Accountability Levels.* Similar to the monitoring process for position limits, on a daily basis, MSD reviews position accountability levels via the Top Day Alert Report and the Over Limits Alert Report. Because MSD intentionally sets accountability levels low, it is not unusual for certain MPs to hold positions in excess of the levels. MSD also uses the Commodity screen in MSA to monitor position accountability levels.

When an MP initially exceeds a position accountability level, MSD attempts to contact the MP directly. If MSD is unable to reach the MP, it will contact the reporting firm carrying the position. MSD will request information regarding the nature of the position (e.g., hedging, speculative, arbitrage), trading strategy, how large the MP anticipates the position may become, and any other information that MSD considers relevant. Such additional information may

include any systems and policies that the MP has implemented for monitoring when spot month position limits take effect, and any internal guidelines the MP may have established regarding the percentage of open interest the MP may hold. MSD maintains notes regarding these discussions.

When instructing an MP pursuant to position accountability rules, MSD will make a determination whether to set a limit on position size, order a position reduction, or take other appropriate action. During the target period, MSD set a limit on MPs' position size on three occasions, requested information about the nature of MPs' positions on three occasions, and instructed one MP to stop increasing its position. MSD did not order any position reductions during the target period. When setting a limit on position size, MSD takes a number of factors into consideration. For a commercial MP, the position limit is based on the MP's bona fide hedging and/or arbitrage needs. For a non-commercial MP, the factors considered include the MP's trading strategy and the history of the MP's activities in Exchange markets. If an MP who exceeds a position accountability level fails to follow instructions issued by the Exchange, MSD regards this action as a position limit violation, and takes appropriate action.

The Division has determined that the Exchange has an adequate procedure for setting and monitoring for position limits and accountability levels. Accordingly, the Division has no recommendations in this area.

B. Exemptions from Position Limits

1. Standard Procedures for Exemption Applications. During the target period, the Exchange received 142 exemption applications. One-hundred twenty-one of the exemption applications related to bona fide hedging requests, while 21 related to arbitrage or cash and carry requests. The Exchange granted 92 new exemptions during the target period.

a. *Single and Net Overall Month Exemptions.* To apply for a single month and/or net overall month position limit exemption, an MP must file an exemption request form with the Exchange. Among other questions, the form asks for the following information:

- What position limits are needed for this firm's hedging, straddle/arbitrage and swap requirements?

- For bona fide hedging requests, provide specific information which will demonstrate that the proposed transactions are bona fide hedging transactions. In particular, describe the size and nature of the cash transactions and/or physical positions to be hedged.
- For notice period or spot month exemptions, indicate whether the cash market transactions described in the form will take place during the delivery period for which the hedge exemption is required.
- For straddle/arbitrage hedging requests, provide specific information that will demonstrate that the proposed transactions are arbitrage or straddle positions as defined in Exchange Rules.

In addition, the form requires the applicant to agree to a number of representations, including the following:

- That the intended transactions are bona fide hedge transactions and/or straddle/arbitrage transactions.
- That the applicant will comply with whatever limitations are imposed by the Exchange with regard to said positions.
- That the applicant will submit a supplemental statement explaining any material change in circumstances affecting the position.
- That the applicant will comply with all other Exchange Rules and requirements.

The form must be signed by an Exchange member or an officer or partner of an Exchange member firm.

When reviewing an exemption request, MSD considers the size of the requested position with respect to open interest, the principal business and occupation of the requestor, the requestor's historical level of futures and options positions, the requestor's assets and obligations in the physical market, and any other information that MSD considers relevant to the request. For hedge exemption requests, MSD relies in part on Commission regulation 1.3(z), discussed in more detail below. MSD considers exemption requests for futures positions related to swaps to be hedge exemption requests.

Within five days of the submission of a completed request, MSD informs the applicant in writing whether the exemption has been granted, partially granted, or denied. MSD records summary information regarding exemption requests. MSD enters approved exemption quantities

for single month and net overall month exemptions into the MSA, along with the date the exemption was granted. MSD also maintains paper files of all documentation related to exemptions requested and granted.

All single month and net overall month exemptions are reviewed annually by MSD to ensure that outstanding exemption levels still reflect the nature and scope of the exemption holder's business. On an annual basis, an MSD analyst sends a letter to either the MP (if a member) or to the clearing firm asking whether the exemption on file is still appropriate and still reflects the party's bona fide hedging needs. If nothing has changed, the party is only required to sign and return the letter. If something has changed, the party must submit a new application. If the party does not respond to the letter, MSD cancels the exemption. MSD enters the date the exemption was granted or updated into the MSA.

The Division is concerned that some MPs could simply sign and return the letter for a period of several years before they would be asked to submit new data supporting their existing level of exemption. This is of note because of the Division's concern about the sufficiency of the original application, as discussed further below. Accordingly, the Division makes the following recommendation to ensure that hedge exemptions granted to MPs are based upon their current hedging needs, and are supported by sufficient documentation.

- **The Exchange should require market participants to resubmit detailed information on at least an annual basis to support their single month and all month hedge exemptions.**

b. *Notice Period, Spot Month and Cash and Carry Exemptions.* Notice period and spot month exemptions are specific to a particular contract. Such exemptions expire on the last notice day for the contract for which the exemption was granted. To apply for a notice period or spot month position limit exemption, an MP must file a request form with the Exchange. When reviewing notice period and spot month exemption requests, MSD considers the size of the requested position with respect to open interest, the principal business and occupation of the requestor, the requestor's historical level of futures and options positions, the requestor's assets and obligations in the physical market, and any other information that MSD considers relevant to the request. MSD places particular emphasis on current cash and futures

commitments, delivery intentions and deliverable supplies. The applicant must justify the entire position requested, not just the amount in excess of the speculative position limit.

For cash and carry exemption requests (discussed in more detail below), the applicant must provide its cost of carry and the minimum spread at which the MP will enter into a straddle position and which would result in an economic profit for the MP. The applicant must also provide the quantity of stocks in Exchange-licensed warehouses that it already owns. The applicant's entire long position carried into the notice period must have been put on as a spread at a differential that covers the applicant's cost of carry.

c. *Provisional Exemptions.* A member whose position is approaching or exceeds current limits may request an exemption or an expansion of current limits by telephoning MSD and orally providing the information needed to process the request. If the exemption is granted, the applicant must file a completed exemption request form with MSD within 24 hours.

Exchange Rule 6.26 states that, "The position limits for Exchange Futures and Options Contracts specified in [Chapter 6 of the Exchange Rulebook] shall not apply to bona fide hedging positions as defined in Section 1.3(z)(1) of the Regulations under the Act." Commission regulation 1.3(z)(1) defines bona fide hedging transactions and positions. The definition provides several examples of bona fide hedging transactions and positions, including sales that do not exceed the ownership or fixed-price purchase of the same cash commodity by the same person and, similarly, purchases that do not exceed the fixed-price sale of the same cash commodity by the same person.⁴²

⁴² Commission regulation 1.3(z)(2)(i) states that the definitions of bona fide hedging transactions and positions include "sales of any commodity for future delivery on a contract market which do not exceed in quantity: (A) Ownership or fixed-price purchase of the same cash commodity by the same person." Commission regulation 1.3(z)(2)(ii) states that the definitions of bona fide hedging transactions and positions include "purchases of any commodity for future delivery on a contract market which do not exceed in quantity: (A) The fixed-price sale of the same cash commodity by the same person." Note that on November 18, 2011, the Commission adopted part 151 to establish a position limits regime for twenty-eight exempt and agricultural commodity futures and options contracts and the physical commodity swaps that are economically equivalent to such contracts (the "Position Limits Final Rule"). See 76 FR 71626 (Nov. 18, 2011). As part of the Position Limits Final Rule, the Commission also adopted changes to Commission regulation 1.3(z). The Position Limits Final Rule was vacated by the United States District Court for the District of Columbia on September 28, 2012, with the result that the pre-existing version of Commission regulation 1.3(z), cited above in this footnote, remains in effect.

Exchange Rule 6.26 requires that MPs submitting a request for a hedge exemption demonstrate that the proposed transactions are bona fide hedging transactions (as defined in regulation 1.3(z)). Notwithstanding this Exchange Rule, the Exchange permits MPs in Sugar to support a request for a hedge exemption with unfixed-price purchases and sales. Such positions do not qualify as bona fide hedging positions under Commission regulation 1.3(z). When Division staff called this inconsistency to the attention of Exchange representatives, they agreed to propose an amendment to the Exchange Rulebook stating that the Exchange will offer hedge exemptions from the position limits for Exchange Futures and Options Contracts for bona fide hedging positions as defined in Section 1.3(z)(1) of the Regulations under the Act (which currently appears in the Rulebook), and also for other non-enumerated hedging positions that are otherwise determined by the Exchange to be consistent with the purpose of hedging (which would be a new addition to the Rulebook). As of the date of this report, the Exchange had committed to make this change to its Rulebook, but had not yet finalized the implementation of the change.

2. Cash and Carry Exemptions. Exchange Rule 6.27 permits Exchange members to apply for a cash and carry exemption in connection with arbitrage, spread and straddle strategies. This type of exemption is unique to the Exchange, and is not offered by other DCMs. Rule 6.27 states in relevant part:

(b) To be eligible for an exemption under this Rule, a Member must submit to the Exchange a written request in the form provided by the Exchange which shall include the following:

...

(vii) when applying for a cash and carry exemption, the trader must provide the cost of carrying the physical commodity, the minimum spread differential at which the trader will enter into a straddle position in order to obtain profit, and the quantity of stocks the trader currently owns in Exchange licensed warehouses or tank facilities.

...

(e) When granted a cash and carry exemption, the trader shall agree that, (i) before the price of the nearby contract month rises to a premium to the second

(2nd) contract month, the trader will liquidate all long positions in the nearby contract, and (ii) the trader will comply with all other restrictions or limitations placed on the trader as a condition to the grant of the exemption.

A cash and carry exemption allows an MP to take delivery in the near month and redeliver the same product in a deferred month at a profit. In carrying-charge markets, current deliverable stocks are usually adequate and prices are higher for deferred expiration months. MPs may request cash and carry exemptions when the spread between the expiring contract and next delivery month exceeds carrying charges. Thus, an MP who has purchased the near month and sold the deferred month may profit by taking delivery and redelivering the next month.

The Exchange approved 21 cash and carry exemptions during the target period. In June 2013, following discussions between the Division and the Exchange regarding cash and carry exemptions, the Exchange reviewed the procedure by which such exemptions are granted. The Exchange opined to the Division that “cash and carry exemptions [are] beneficial for the market, particularly when there are plentiful warehouse stocks, which typically is the only time when the opportunity exists to utilize the exemption.” The Exchange also opined that “the current Exchange rules and procedures [are] effective in ensuring orderly liquidations.”

The Division is continuing to review the effectiveness of the Exchange’s cash and carry exemptions and the procedure by which the Exchange grants such exemptions.⁴³ As a result, the Division is not making any determinations with respect to the cash and carry exemption in connection with this rule enforcement review.

⁴³ In the event that the Division determines that the Exchange’s cash and carry exemptions and the procedure by which the Exchange grants such exemptions may not be effective, the Division will contact the Exchange to address this issue.

3. The Division’s Review of Particular Exemption Files. As discussed in Section IX(B)(1) above, when completing an exemption request form, the applicant must complete several detailed questions, which request information on the size of position requested and, if for bona fide hedging, specific information that demonstrates that the proposed transactions are intended for hedging purposes, including the size and nature of the cash transactions/positions to be hedged. Additionally, exemption applications require information concerning the MP’s relationship to other MPs/accounts, and various representations concerning the obligations placed on the MP when granted an exemption. Applicants requesting a Cotton exemption must also file a copy of the latest Form 304 report that they filed with the Commission.

During the target period, the Exchange received 142 exemption applications. One-hundred twenty-one of the exemption applications related to bona fide hedging requests, while 21 related to arbitrage or cash and carry requests. The Exchange granted 92 new exemptions during the target period. The Division reviewed 25 representative exemption applications of the 142 applications that were received by the Exchange. The Division concluded that applicants sometimes do not fill out the form completely, *i.e.*, some questions are not answered, and the answers to some questions are not complete. Some examples are illustrated below:

- One MP stated in its exemption application that it “has net unfilled physical delivery obligations of [a stated amount] of nearby commitments and we will potentially look to satisfy via Exchange delivered product...”
- Another MP stated the following in its exemption application: “Current inventory = [x] million [in a stated commodity], Purchases = [x] million [commodity], Committed sales = [x] million [commodity], Ending inventory (deficit) = [x] million [commodity] or [x] contracts.”⁴⁴

The requested exemptions were granted to both MPs. In these two examples, the MPs did not indicate whether the “unfilled... obligations” or “committed sales” referenced in the applications are fixed-price sales contracts, as required by the application form. Furthermore, if the first MP’s unfilled nearby commitments represent processing requirements, any hedges granted are restricted during the last five trading days of contract expiration. The documents

⁴⁴ The Division has redacted the exemption applications discussed in this section in order to preserve the confidentiality of the market information presented and the identity of the applicants.

provided by the Exchange contained other hedging exemption requests that were not fully completed.

The Division believes applicants did not provide enough information in these responses for the Exchange to adequately assess the merits of the hedging exemptions requested. MPs omitted certain critical information, including specific numbers for their inventories and sales commitments, the time period of MPs' sales commitments, and whether the sales were fixed or unfixed price. The Exchange did not provide documentation indicating whether the missing data was elicited from the MP by other means (for example, in telephone conversations). The Division makes the following recommendation to increase the amount and accuracy of information provided on exemption applications, and to ensure that the Exchange receives sufficient information to analyze whether an exemption sought is appropriate:

- **Prior to granting a hedge exemption, the Exchange must ensure that applicants complete each question in their exemption applications. The Exchange must also ensure that applicants provide sufficiently detailed information to allow the Exchange to analyze the underlying reasons for the request, and whether those reasons are consistent with the requirements for the exemption sought.**

X. REVIEW OF MARKET SURVEILLANCE INVESTIGATIONS

A. General Procedures

MSD conducts investigations of potential violations of Exchange Rules and other applicable regulations, such as position limit violations and misreporting of open interest. When MSD completes an investigation, MSD prepares an investigation report recommending appropriate action—e.g., that MSD refer the matter to an Exchange disciplinary panel, or issue a staff warning letter or fine. MSD considers an investigation closed on one of two different dates, depending on how the investigation is ultimately resolved. If the investigation is not referred to a disciplinary panel, the close date is considered to be the date that is recorded on the MSD investigation report. If the investigation is referred to a disciplinary panel, the close date is considered to be the date the investigation is initially presented to the Business Conduct Committee. MSD attempts to complete investigations in less than one year. MSD does not have

a manual setting forth the procedures to be followed in conducting investigations. Investigations are completed and documented in largely the same manner by both the Market Surveillance Department and the Compliance Department, which does rely on a procedures manual to conduct investigations. Documentation related to MSD investigations is maintained in paper format.

B. Review of Investigations During Target Period

1. Overview. The Division reviewed 10 MSD investigations in connection with this rule enforcement review. These 10 investigations represent all of the investigations that were open during any portion of the target period. Three of the 10 were opened before the beginning of the target period, with the remaining seven opened during the target period. Six of the 10 investigations were closed during the target period, with three closed after the end of the target period. In addition, one investigation opened during the target period was suspended by the Exchange upon being separately investigated by the Commission's DOE.⁴⁵ Nine of the 10 investigations have therefore been closed.

Five of the closed investigations were resolved by MSD through the issuance of a warning letter. Four of the closed investigations were resolved pursuant to settlement agreements, involving fines of \$20,000 (case # 2012-002), \$25,000 (case # 2011-070), \$50,000 (case # 2010-071) and \$100,000 (case # 2011-056). The respondent in case # 2012-002, also discussed in Section VII(A) above, inaccurately reported open interest. The respondent in case # 2011-070 violated Exchange position limit rules by maintaining a short position in Cotton No. 2 for a corporate affiliate that exceeded the net futures equivalent all months position limit. Similarly, the respondent in case # 2010-071 violated Exchange position limit rules by maintaining a short position in Cotton for a corporate affiliate that exceeded the net futures equivalent single month position limit. The respondent in case # 2011-056 failed to comply with the restrictions of a cash and carry exemption granted by the Exchange.

Four of the 10 investigations related to position limit violations; one investigation related to failure to comply with the restrictions of a cash and carry exemption granted by the Exchange; one investigation related to large trader reporting deficiencies; two investigations related to open

⁴⁵ The Exchange suspended its investigation, but kept the investigation open, based on instructions provided by DOE.

interest reporting deficiencies; one investigation related to a rule violation in connection with several Exchange of Options for Options transactions; and one investigation was suspended by the Exchange upon being separately investigated by the Commission's DOE. The Division believes that the analysis performed by MSD in the course of the 10 investigations was generally thorough and well-reasoned. The Division notes that case numbers were not assigned to two investigations during the target period, and formal investigation reports were not prepared by MSD in connection with these investigations. The Exchange has informed the Division that in May 2012, MSD procedures were changed to require that case numbers be assigned and an investigation report be prepared for matters that appear to involve an Exchange rule violation, regardless of whether the matters are resolved without findings of rule violation or result in summary action, such as an MSD warning letter or summary fine. During its next rule enforcement review of the Exchange, the Division will evaluate MSD's compliance with this May 2012 policy. The Division also notes that two investigation reports from the first half of 2012 were not dated by MSD staff. The Division recommended in a rule enforcement review of the Exchange's disciplinary program, dated December 14, 2012, that the Exchange should record the date in investigation reports on which the reports are approved by senior Compliance staff. The Division understands that the Exchange implemented this recommendation in both its Compliance and Market Surveillance departments following the December 2012 rule enforcement review. The Division will evaluate the Exchange's compliance with this recommendation during its next rule enforcement review of the Exchange. Subject to the foregoing, the Division believes that the 10 investigations reviewed were sufficiently documented. Furthermore, the Division believes that the sanctions imposed by the Exchange via warning letters and monetary fines appear generally reasonable relative to the violations alleged and evidence presented.

2. *Timeliness of Proceedings.* The average length of time between the opening and closing of the nine investigations closed during the target period was 288 days.⁴⁶ With respect to the nine closed investigations, the shortest and longest time between the date an investigation

⁴⁶ MSD considers an investigation closed on one of two different dates, depending on how the investigation is ultimately resolved. If the investigation is not referred to a disciplinary panel, the close date is considered to be the date that is recorded on the MSD investigation report. If the investigation is referred to a disciplinary panel, the close date is considered to be the date the investigation is initially presented to the Business Conduct Committee.

was opened and the date it was completed was 14 days and 652 days, respectively. Four of the nine closed investigations took over one year to complete: 424 days, 450 days, 501 days and 652 days. The Division is particularly concerned with the timing of two of these investigations. One investigation took 501 days to complete with no apparent mitigating circumstances justifying the prolonged open period. The investigation involved a position limits violation that occurred in November 2010. The Exchange closed the investigation in March 2012 by issuing a warning letter. Another investigation, involving failure to comply with a cash and carry exemption, took 652 days to complete. The Exchange closed the investigation in July 2013 via a settlement agreement that provided for a \$100,000 fine. Although the Division acknowledges that this investigation involved extended negotiations, the Division believes that the Exchange should have resolved the investigation more expeditiously than 652 days.

As noted above, the Exchange informed the Division that the Market Surveillance Manager left the Exchange following the end of the target period. The Exchange also stated that, in an effort to reduce the time required to resolve surveillance investigations, the Exchange assigned the duties of the Market Surveillance Manager to the MSD Senior Analyst.⁴⁷ In light of the four investigations open for substantially more than a year (including one investigation with no apparent mitigating circumstances, along with another investigation open for 652 days), as well as the reduction in staffing and personnel change within MSD, the Division encourages the Exchange to maintain sufficient staffing within MSD to promptly fulfill all of its surveillance and investigatory responsibilities.⁴⁸

⁴⁷ As noted above in Section V(C), the Senior Analyst has 13 years of commodities industry experience and is being trained in all aspects of market surveillance.

⁴⁸ See also the Division's recommendation with regard to staffing in Section V(C) above: "The Exchange should ensure that MSD maintains staffing sufficient to perform all of its surveillance responsibilities, including timely completion of surveillance investigations."