

**RULE ENFORCEMENT REVIEW  
OF THE NEW YORK MERCANTILE  
EXCHANGE AND THE COMMODITY  
EXCHANGE**



**Division of Market Oversight  
August 30, 2011**

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## I. EXECUTIVE SUMMARY

The Division of Market Oversight (“Division”) has completed a rule enforcement review of the audit trail, trade practice surveillance, and disciplinary programs of the New York Mercantile Exchange, Inc. (“NYMEX”) and the Commodity Exchange, Inc. (“COMEX”) (hereafter, collectively “Exchange”), wholly-owned subsidiaries of CME Group, Inc. (“CME Group”), for compliance with related core principles under Section 5(d) of the Commodity Exchange Act (“Act”), as amended by the Commodity Futures Modernization Act of 2000, and Part 38 of the Commission’s regulations.<sup>1</sup> The review covers trading on NYMEX and COMEX during the period of January 1, 2009 to December 31, 2009 (“target period”).<sup>2</sup>

The review focused on Core Principles 10, *Trade Information*, and 17, *Recordkeeping*, which relate to an exchange’s audit trail program for the recording and safe storage of trade information in a manner which enables prevention of customer and market abuses and enforcement of exchange rules; and Core Principles 2, *Compliance With Rules*, and 12, *Protection of Market Participants*, which relate to an exchange’s program for enforcing its rules, conducting disciplinary proceedings, and protecting market participants from abusive practices.<sup>3</sup>

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<sup>1</sup> 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.

<sup>2</sup> As explained on page eight of this report, NYMEX and COMEX merged in 1994 and subsequently became wholly-owned subsidiaries of NYMEX Holdings, Inc. Following the August 2008 merger between NYMEX Holdings, Inc. and CME Group, Inc., NYMEX and COMEX became wholly-owned subsidiaries of CME Group, Inc. Each CME Group exchange (CME, CBOT, NYMEX and COMEX) is separately registered as a designated contract market (“DCM”) under the Act.

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

For purposes of this review, Division staff interviewed compliance officials and staff from the CME Market Regulation Department (“Market Regulation”), which provides compliance and self-regulatory services to NYMEX and COMEX, pursuant to a Regulatory Services Agreement.<sup>4</sup> The Division also reviewed numerous documents used by Market Regulation in carrying out the self-regulatory responsibilities of the Exchange. These documents included, among other things, the following:

- demonstration of automated surveillance systems used by the Exchange to conduct audit trail reviews and trade practice surveillance;
- audit trail review and trade practice investigation files;
- trade practice investigation, floor surveillance, disciplinary, and arbitration logs;
- disciplinary case files;
- minutes of disciplinary committee, Board of Directors (“Board”), and Market Regulation Oversight Committee meetings held during the target period; and
- compliance procedures manuals and guidelines.

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Part 38, the Commission reserved the authority to adopt acceptable practices for Core Principle 12 at a later date. Appendix B to Part 38 provides acceptable practices for demonstrating compliance with these core principles.

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) into law. Section 735 of the Dodd-Frank Act amended Section 5 of the Commodity Exchange Act pertaining to the designation and operation of contract markets. On December 22, 2010, the Commission proposed new and revised rules, guidance and acceptable practices implementing Section 5 of the Act, as amended by the Dodd-Frank Act (75 FR 80572). Upon the issuance of final rules implementing Section 5 of the Act, as amended, DCMs will be subject to the new and revised regulations in accordance with the effective date of the final rulemaking.

<sup>4</sup> Division staff also interviewed the members of the CME Group Market Regulation Oversight Committee (“MROC”), which provides independent oversight of the policies and programs of the Market Regulation Department. The interview was conducted only to increase the Division’s understanding of the operations of the MROC. This review does not contain any judgments with respect to the Exchange’s compliance with Core Principle 15, *Conflicts of Interest*.

The Division provided the Exchange an opportunity to review and comment on a draft of this report on June 29, 2011. On July 7, 2011, Division staff conducted an exit conference with Market Regulation staff to discuss the report's findings and recommendations.

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

### **A. Market Regulation Staff**

#### **Findings**

- During the target period, CME Group integrated the NYMEX Compliance Department into the CME Market Regulation Department as a result of the merger between NYMEX and COMEX with the CME Group. After the integration, Market Regulation consisted of 133 persons, 39 of whom work from the Exchange's New York Office and are primarily assigned to carry out the self-regulatory obligations for NYMEX, including the Chief Regulatory Officer for all of the CME Group exchanges and his Executive Assistant; a 14-member Investigations Group, responsible for trade practice surveillance and investigations; a three-person Enforcement Group, responsible for prosecuting disciplinary cases; one person each in the Strategic and Technology Initiatives Group and the Employee Development Initiatives Group; and an 18-person Market Surveillance Group (whose work is not covered in this review).
- The number of Market Regulation staff assigned to detecting, investigating, and prosecuting potential trading violations for NYMEX during the target period is unchanged since the Division's last rule enforcement review in 2004 ("2004 Review").
- Although Market Regulation plans to add two investigator positions in 2011 that will be assigned to NYMEX, nearly the same number of NYMEX dedicated compliance staff are responsible for overseeing approximately a 131 percent increase in the volume of trading, an increase of 484 products traded since the Division's 2004 Review, and carrying out regulatory services for the Green Exchange and CME Clearing Europe (two entities that did not exist at the time of the 2004 Review).

#### **Recommendations**

- The Exchange should continue to take such ongoing steps as necessary to ensure that Market Regulation staff is increased appropriately whenever necessary in light of trading volume, products traded, futures and options industry changes, new responsibilities assigned to Market Regulation, or other relevant developments.

### **B. Audit Trail**

#### **Findings**

- The Exchange maintains an adequate audit trail program, which records trade data in a manner that enables NYMEX to identify customer and market abuses and provide evidence of rule violations.
- CME Globex, the Exchange's electronic trading platform, maintains a complete electronic record of all orders entered and transactions executed, including all messages entered into the system, the terms of each order, all order modifications, all matched



trades, and the time of each message. This record enables the Exchange to reconstruct electronic trading efficiently and effectively.

- For open outcry trading, the Exchange maintains a traditional audit trail for all orders transmitted to the pit by flashed hand signals, physical delivery of order tickets, or electronic order routing. This record enables the Exchange to reconstruct open outcry trading efficiently and effectively.
- Market Regulation monitors compliance with electronic trading recordkeeping requirements through annual “Globex audits” at each clearing member. These audits use computerized surveillance tools to review electronic audit trail data for trades guaranteed by the clearing member to detect instances of potential audit trail violations.
- Market Regulation monitors individual member compliance with open outcry recordkeeping rules through regular review of computerized recordkeeping exception reports, and reviews member compliance with open outcry recordkeeping requirements through member and firm trading card and order ticket audits. There were fewer firm audits conducted during the target period when compared with the 2004 Review as a result of the decline in open outcry trading.

### **Recommendations**

- The Division has no recommendations in this area.

### **C. Trade Practice Surveillance**

#### **Findings**

- The Exchange maintains an adequate trade practice surveillance program. Market Regulation monitors all electronic and open outcry trading activity through computerized surveillance applications. It also monitors all open outcry trading at the Exchange through floor surveillance, a new, advanced video surveillance system, and Exchange recording of all floor telecommunications. Market Regulation conducts various types of investigations across all markets at the Exchange in a manner capable of detecting trading activity prohibited by Exchange rules.
- During the target period, Market Regulation closed 59 trade practice investigations, including 27 investigations involving electronic trading, 24 investigations involving open outcry trading, and eight investigations that involved side-by-side trading in both electronic and open outcry venues.
- The Division reviewed all of the 59 investigations closed during the target period and found that the investigations were thorough and well-documented, and included appropriate, well-founded analyses. A number of complex investigations involved analysis of substantial amounts of data and extended periods of trading activity. Market Regulation completed investigations within a reasonable timeframe.

## **Recommendations**

- The Division has no recommendations in this area.

## **D. Disciplinary Program**

### **Findings**

- The Exchange maintains an adequate disciplinary program, which enables the Exchange to take effective disciplinary action when rule violations are suspected. Exchange rules ensure due process for disciplinary proceedings, and give the Exchange the authority to discipline, suspend, or permanently bar members or market participants found to have committed rule violations.
- The Exchange closed 27 disciplinary cases involving 55 respondents during the target period. Nineteen of the 55 respondents resolved their cases through contested hearings before the Business Conduct Committee (“BCC”) and 36 respondents concluded their cases with settlement agreements.
- In the 27 closed cases, the Exchange assessed a total of \$1,962,000 in fines, including fines against 53 individuals and 2 member firms. Twelve individuals were ordered to pay a total of \$416,138 in customer restitution. The Exchange suspended 21 individuals for a total of 532 days, and imposed permanent bars on membership or association with any member or member firm against 11 individuals.
- The Division reviewed all 27 closed disciplinary cases, and found that most sanctions imposed appear reasonable relative to the violations alleged and the evidence presented. However, the Division identified one case in which a floor broker received a \$5,000 fine and a five-week suspension from membership for noncompetitive trading, prearranged trading, withholding orders, and conduct detrimental to the Exchange. In 2008, the same floor broker received an \$85,000 fine, an eight-week suspension from membership, and a five-year ban from executing customer orders for similar violations. Given the floor broker’s disciplinary history, the Division believes a larger sanction was warranted.
- The Division found that in 19 of the 27 closed disciplinary cases, a disciplinary committee decision was issued and the case was closed less than one year following referral of the investigation into the disciplinary process. Five of the eight cases that remained in the disciplinary process for more than one year included mitigating factors that justified the longer periods of time for resolution. However, the Division identified three cases where the BCC failed to promptly issue a written decision of the panel’s findings following a hearing.
- Most BCC decisions in matters involving contested hearings or consideration of settlement offers opposed by Market Regulation were adequately explained in the BCC’s written decisions. However, in one case in which the BCC accepted unsupported settlement offers for six respondents in a prearranged trading case, the BCC’s minutes failed to address whether the committee considered the disciplinary history of two of the

six respondents who had been recently sanctioned by the Exchange in separate matters for substantive trade practice violations.

- In one case, in which the Probable Cause Committee (“PCC”) rejected Market Regulation’s recommendation to issue charges against two traders in a case involving prearranged and noncompetitive trading, the PCC failed to explain its decision in a manner sufficient to enable thorough Division review of the Exchange’s disciplinary program.

### **Recommendations**

- The Exchange should ensure that the BCC imposes meaningful sanctions on members who violate the same or similar Exchange rules to discourage recidivist activity.
- The Exchange should take appropriate action to ensure that disciplinary decisions are issued promptly after a hearing.
- The Exchange should ensure that all written decisions by the BCC, including acceptance of unsupported settlement offers, and all decisions by the PCC not to issue charges, are adequately explained in writing in committee minutes. The written decisions should include findings and conclusions with respect to each charge, and the findings with respect to each charge should state and explain the reason or reasons for the committee’s conclusion with respect to that charge, note the evidence which led the committee to that conclusion, and explain the basis for the sanction imposed. The committee’s decision should also explain the role, if any, that a respondent’s disciplinary history factored into decisions to accept unsupported settlement offers and decisions regarding sanctions.

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

Since the Division's last rule enforcement review examining the audit trail, trade practice, and disciplinary program at NYMEX issued on September 16, 2004 ("2004 Review"), the Exchange experienced a number of significant developments that have had a material impact on its organizational structure and its business.<sup>5</sup> The most noteworthy of these changes include the following:

- **Demutualization and Merger.** At the time of the 2004 Review, NYMEX was owned by its members. On November 16, 2006, NYMEX was demutualized, and the Exchange became a publicly held corporation whose shares traded on the New York Stock Exchange. On August 22, 2008, NYMEX was purchased by CME Group Inc., and the Exchange became a wholly-owned subsidiary of CME Group Inc. As part of the same transaction, CME Group Inc. also acquired COMEX, which has operated as a subsidiary of NYMEX since 1994. As a matter of form, both NYMEX and COMEX also continue to operate as separately designated contract markets owned by CME Group Inc.<sup>6</sup> With respect to the compliance and self-regulatory program, NYMEX shares both substantially harmonized rules and a common Market Regulation Department with the other CME Group exchanges, which include CME and the Chicago Board of Trade ("CBOT"), (collectively, "the Exchanges").<sup>7</sup> CME's Market Regulation Department provides regulatory services to NYMEX, pursuant to a Regulatory Services Agreement between the two Exchanges dated August 25, 2008.<sup>8</sup>

- **Trading Volume Growth.** During the time between the 2004 Review and the current review period, NYMEX more than doubled its total trading volume, as shown in Figure 1 below.<sup>9</sup>

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<sup>5</sup> The 2004 Review covered the period of January 1, 2003 through December 31, 2003. The Division also completed a rule enforcement review of the Exchange's market surveillance program (not covered in this review) on May 19, 2008.

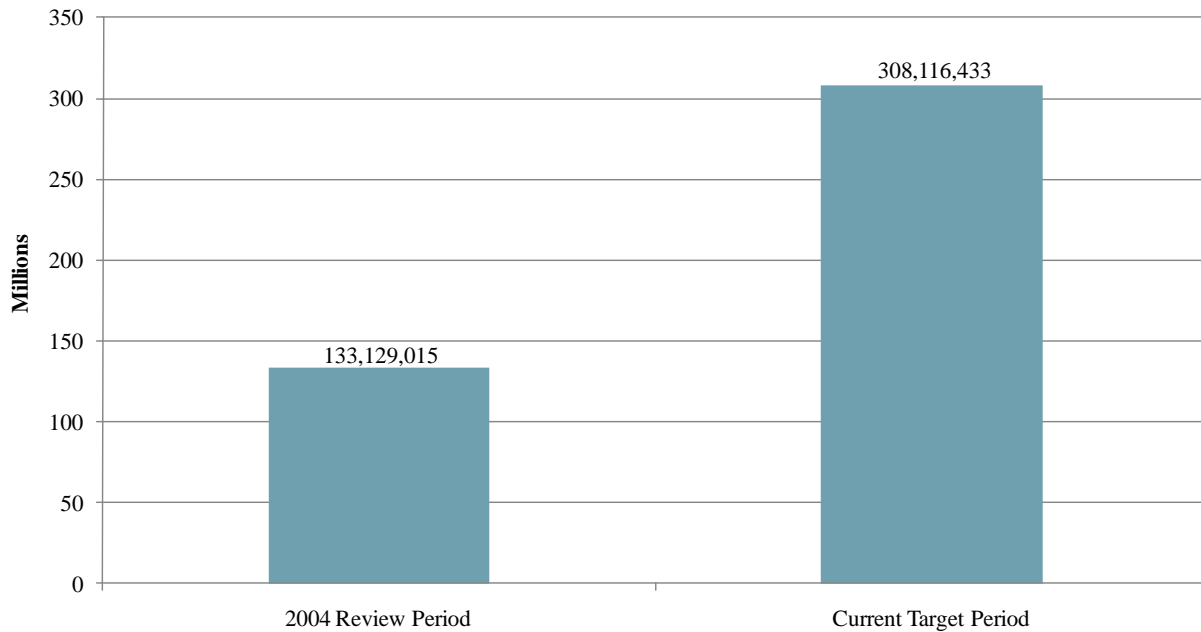
<sup>6</sup> On July 12, 2007, CBOT Holdings, Inc., the parent company of CBOT, merged with Chicago Mercantile Exchange Holdings Inc., the parent company of CME. As a result of the merger between CBOT and CME, both exchanges became wholly-owned subsidiaries of CME Group Inc. CBOT and CME continue to maintain independent registration status as DCMs, and they remain separate self-regulatory organizations.

<sup>7</sup> As reported to the Commission in an Informational Memorandum from the Division dated March 10, 2010, the Division reviewed the changes made to the Exchanges' rules in the rulebook harmonization process, and found that none of the changes were inconsistent with the Act or the Commission's regulations.

<sup>8</sup> CME's Market Regulation Department also provides regulatory services to CBOT, pursuant to a Regulatory Services Agreement between the two Exchanges dated July 13, 2007.

<sup>9</sup> The total trading volume reported in Figure 1 does not include over-the-counter transactions cleared through ClearPort Clearing.

**Figure 1 – Volume Growth of 131% Between Target Periods**

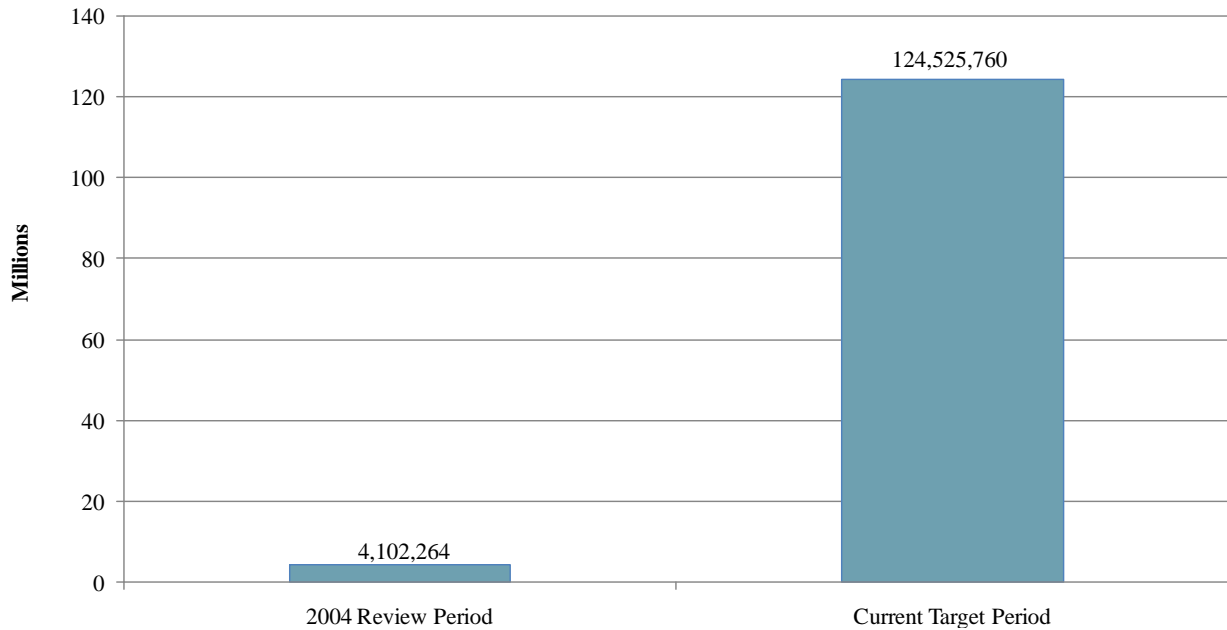


◦ **Volume Growth in ClearPort Clearing.** As noted below in Figure 2, the total volume of over-the-counter transactions cleared through ClearPort Clearing increased by approximately 2,935 percent from the 2004 Review.<sup>10</sup>

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<sup>10</sup> NYMEX offers clearing services for over-the-counter energy and metals transactions through the CME ClearPort Clearing system. In August 2009, CME Group decommissioned the ClearPort Trading System, which listed over 560 futures products for trading. These products remain available for trading in the open outcry venue or, in a small number of products, on Globex. However most of the products' volume is executed bilaterally and submitted for clearing through CME ClearPort.

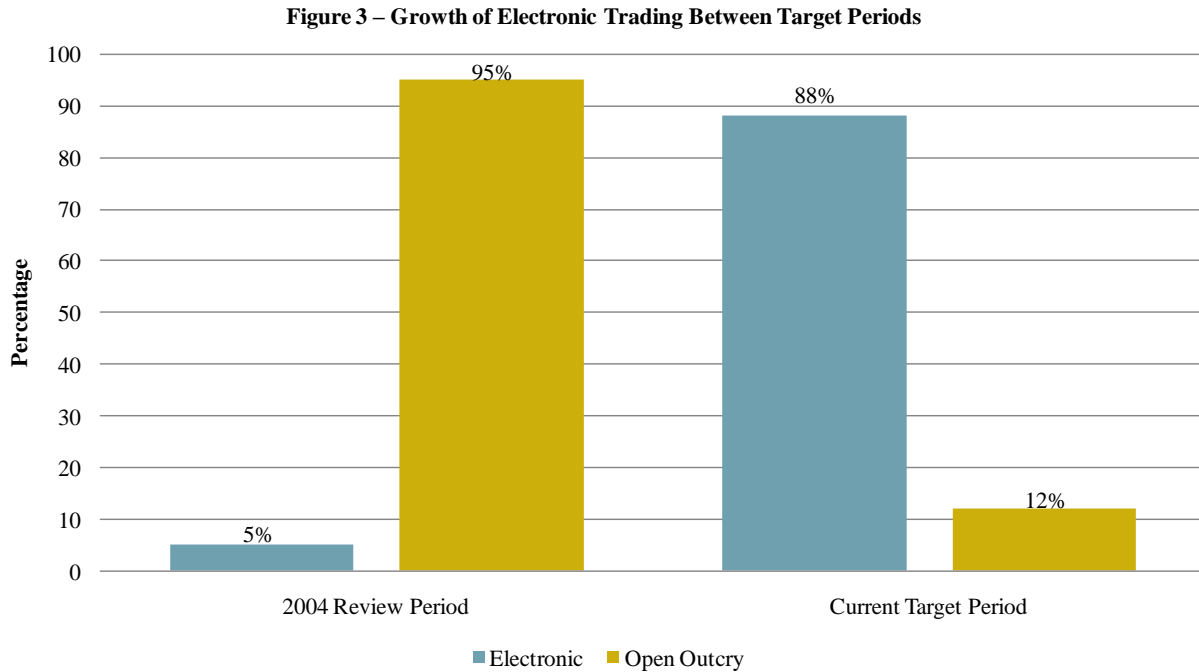
**Figure 2 – 2,935% Increase in ClearPort Clearing Volume Between Target Periods**



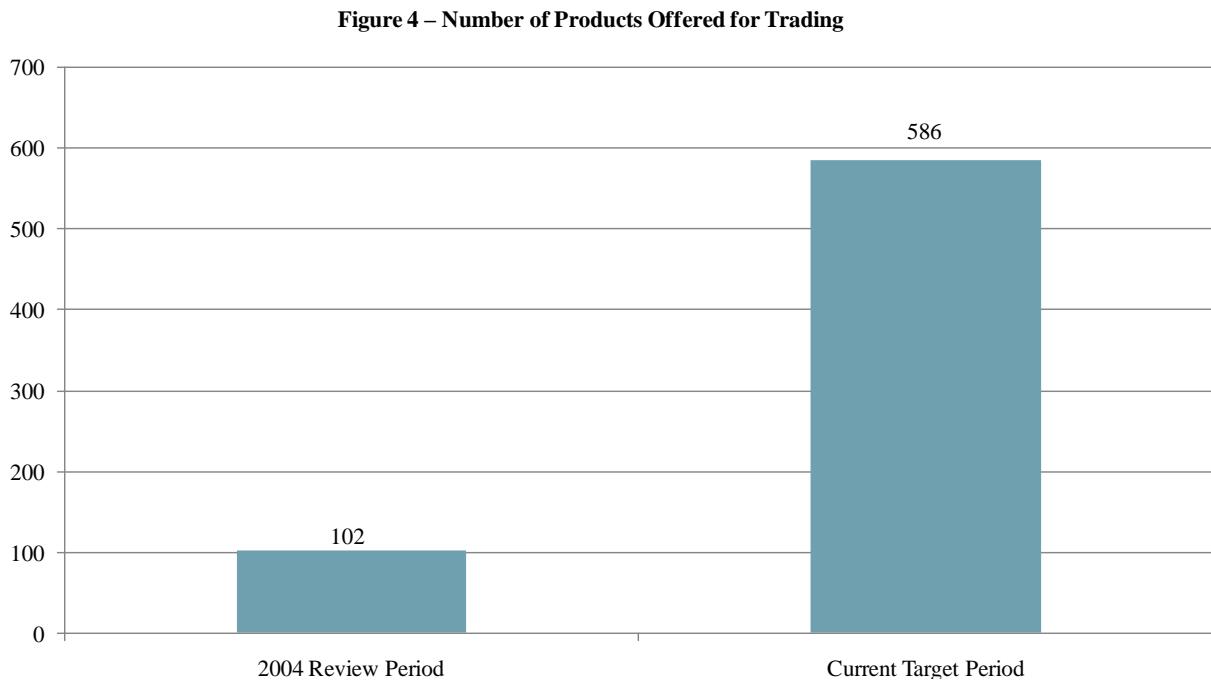
◦ **Expansion of Electronic Trading and Contraction of Open Outcry for Futures Trading.** During the target period for the 2004 Review, approximately five percent of the Exchange’s average monthly volume was traded on NYMEX’s ACCESS electronic trading system (*See* Figure 3). In late 2006, the Exchange commenced electronic trading on the CME Globex system, pursuant to an agreement between NYMEX and CME. By December 2009, NYMEX trading on Globex accounted for approximately 88 percent of the Exchange’s monthly volume.<sup>11</sup> Open outcry trading remains the preferred method of trading options at the Exchange with approximately 87 percent of the volume still traded on the floor. Market Regulation estimates that the floor population at the end of the target period to be 120 floor traders for COMEX and 305 floor traders for NYMEX, which is approximately a 50 percent reduction since the 2004 Review.

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<sup>11</sup> On May 18, 2009, NYMEX and COMEX consolidated all open outcry trading from two trading floors to one trading floor.



◦ **Product Line Expansion.** The Exchange product line expanded by approximately 474 percent from the 2004 Review (See Figure 4). Of the 586 products offered for trading during the target period, West Texas Intermediate Light Sweet Crude Oil, Natural Gas, and Gold futures are the most actively traded contracts at the Exchange and collectively accounted for approximately 72 percent of the total volume during the target period.



## **IV. MARKET REGULATION STAFF**

### **A. Market Regulation Department**

Following the August 2008 merger, the NYMEX Compliance Department and CME Market Regulation Department operated as two distinct groups until November 2009. In November 2009, CME Group completed the restructuring of Market Regulation with the integration of the NYMEX compliance staff into Market Regulation. As noted above, Market Regulation now provides compliance services for all four of the CME Group exchanges.<sup>12</sup>

At the time of the 2004 Review, the NYMEX Compliance Department had 16 compliance staff members who were responsible for detecting, investigating, and prosecuting potential trading violations for both the NYMEX and COMEX Divisions. During the target period and just after the November 2009 integration of the compliance departments, the number of NYMEX compliance staff responsible for those same functions remained unchanged.

With the integration of the NYMEX compliance staff into Market Regulation, the Department (as of March 2011) includes a total of 133 staffed positions.<sup>13</sup> Of the 133 staffed positions, 39 are based in New York and are assigned to carry out the self-regulatory obligations for NYMEX, although Market Regulation staff may have compliance responsibilities that span multiple exchanges. Today, Market Regulation is led by CME Group's experienced management team, including a Corporate Counsel and Corporate Secretary (nine years of

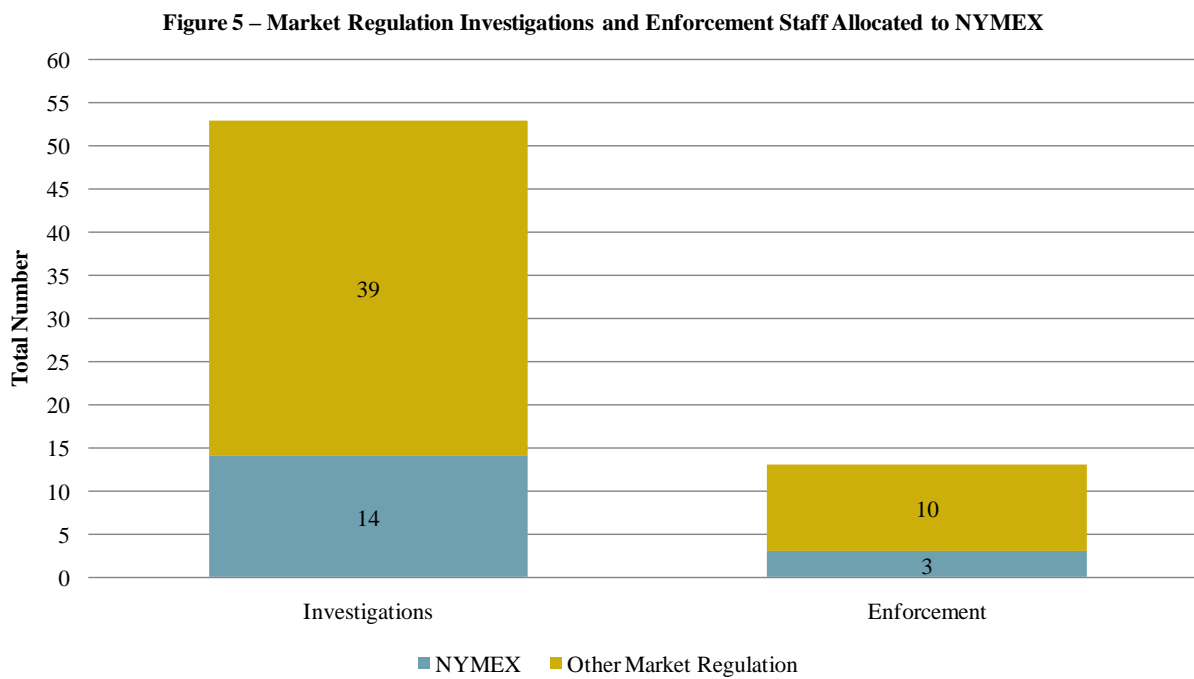
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<sup>12</sup> In September 2010, the Division issued a joint rule enforcement review of CME and CBOT. That review examined the exchanges' compliance with core principles relating to their audit trail, trade practice surveillance, and market surveillance programs. The Division noted in that review that the CME Group followed a more prudent course with respect to the integration of NYMEX compliance staff into Market Regulation, in comparison to the integration of CBOT's Office of Investigations and Audits into Market Regulation, which resulted in merger-related compliance staff reductions. Market Regulation informed the Division that it left the NYMEX Compliance Department in place until regulatory systems had been integrated and rules had been harmonized as a result of lessons learned from the CBOT-CME merger.

<sup>13</sup> As of March 2011, seven Market Regulation positions were vacant. Therefore, at full strength, Market Regulation would include a total of 140 funded positions. Of the seven positions, one Market Surveillance position will be assigned to NYMEX.



exchange experience); a Chief Regulatory Officer (25 years of exchange experience); and a Deputy Chief Regulatory Officer (23 years of exchange experience).<sup>14</sup> As illustrated below in Figure 5, the Investigations Group is responsible for trade practice surveillance and investigations consists of 53 individuals, 14 of whom are dedicated to NYMEX.<sup>15</sup> The Enforcement Group is responsible for prosecuting disciplinary cases consists of 13 individuals, three of whom are dedicated to NYMEX (*See* Figure 5).



The Strategic and Technology Initiatives Group is responsible for coordinating the development of CME Group’s regulatory systems and addressing regulatory considerations with respect to

<sup>14</sup> The senior management team also includes the Director of Global Market Investigations (26 years of industry related experience); the Global Enforcement Counsel (approximately four years of exchange experience and eight additional years of industry related experience); the Director of Global Market Surveillance (26 years of exchange experience); and the Director of Global Market Regulatory Strategy and Technology (33 years of exchange experience). The Division notes that following the November 2009 restructuring of Market Regulation, the senior management team at CME Group maintains responsibilities associated with all four CME Group exchanges, including NYMEX.

<sup>15</sup> As discussed in Section VII(C) of this report, during the review period, one staff person in the Legal Department at the Exchange was responsible for advising the disciplinary panels and supporting the decision and appeal process, including the drafting of disciplinary decisions and one person was also available to serve in a back-up capacity.

strategic initiatives and new product launches consists of 19 individuals, one of whom is assigned to NYMEX. Within the Strategic Technology Initiatives Group, the Data Quality Assurance Group consists of 11 staff members who monitor trading floor recordkeeping for the Chicago markets and electronic audit trail compliance for all four CME Group exchanges, including NYMEX.<sup>16</sup>

In its 2010 Review of CME and CBOT, the Division expressed concern that the staffing levels during the target period had been reduced despite significant increases in volume and the number of products traded. Adequate staffing of compliance responsibilities at the four CME Group exchanges is of particular concern because of the substantial share of the entire U.S. futures and options marketplace accounted for by the CME Group exchanges. Therefore, the Division recommended that CME Group undertake a comprehensive review of the compliance staff needed to ensure that the compliance services provided to all CME Group exchanges by Market Regulation remain effective in meeting its self-regulatory responsibilities. In response to the Division's recommendation, Market Regulation conducted a staffing study and recommended to CME Group's MROC that 11 new Market Regulation positions be added in 2011.<sup>17</sup> The study was reviewed by the MROC, which concurred with the recommendations, and the 11 new positions were approved by senior management at CME Group. Of the 11 new Market Regulation positions, two investigator positions assigned to NYMEX will be added to the Investigations Group.<sup>18</sup> Overall, Market Regulation's headcount will increase to 151 staff

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<sup>16</sup> The Market Regulation staff also includes the Employee Development Initiatives Group, which consists of three staff members, including one person that is assigned to NYMEX. Additionally, the Market Regulation staff includes the Market Surveillance Group, responsible for market surveillance (and thus not addressed in this review), consists of 40 individuals, including 18 that are assigned to NYMEX.

<sup>17</sup> The study also recommended that a current development position in the Strategic and Technology Initiatives Group that was previously designated as transitional through February 2011 be retained.

<sup>18</sup> The Market Surveillance Group will also add two analyst positions assigned to NYMEX products.

members, of which 43 staff members will be primarily dedicated to NYMEX. The Division was pleased to learn that CME Group approved two investigator positions to be assigned to NYMEX. However, the Division notes that the two positions were added in part to assume the additional responsibilities associated with performing regulatory services for the Green Exchange and CME Clearing Europe. The Division also notes that, when combined with NYMEX's approximately 11 percent and COMEX's two percent share of the industry's volume, the CME Group exchanges collectively account for approximately 97 percent of all futures and options trading volume regulated by the Commission. Since Market Regulation is responsible for compliance oversight with respect to such a large share of industry volume, the adequacy of staffing—on which the adequacy of the compliance programs of all CME Group exchanges depends—takes on critical importance. Consequently, the Division is concerned that even with the addition of two investigator positions, nearly the same number of NYMEX dedicated compliance staff are responsible for overseeing approximately a 131 percent increase in the volume of trading, an increase of 484 products traded since the Division's 2004 Review, and carrying out regulatory services for two entities that did not exist at the time of the 2004 Review (Green Exchange and CME Clearing Europe). The Division recognizes that a fully-integrated Market Regulation Department includes some Chicago-based personnel who have responsibility for certain NYMEX regulatory functions, including the four Global Heads of Market Regulation's functional areas and the Data Quality Assurance Group. The Division also recognizes that additional Chicago-based staff members who are responsible for overseeing the compliance responsibilities for other CME Group exchanges could be available to assist the NYMEX staff in times of need. However, such a scenario, in the Division's view, could have the unintended

consequence of hampering the self-regulatory responsibilities for other CME Group exchanges as a result of any shift in resources.

## **B. Conclusions and Recommendations**

The Market Regulation Department consists of highly experienced professionals with many years of employment at the Exchange and elsewhere in the futures industry and is led by CME Group's management, including a Corporate Counsel and Corporate Secretary, a Chief Regulatory Officer, and a Deputy Chief Regulatory Officer. During the target period, the Market Regulation staff responsible for detecting, investigating, and prosecuting potential trading violations at NYMEX included a total of 16 individuals, the same number of staff members that were responsible for those functions during the 2004 Review. At the same time, the Exchange's average monthly trading volume of approximately 26 million contracts per month represented an increase of approximately 131 percent since the 2004 Review.

Adequate staffing is critically important to Market Regulation's ability to conduct adequate and effective compliance oversight. The Division recognizes that a fully-integrated Market Regulation Department, which includes 94 additional staff members who are primarily responsible for overseeing the compliance responsibilities for other CME Group exchanges, could be available to assist the NYMEX staff. Nevertheless, the Division believes that NYMEX should continue to monitor whether the size of its compliance staff is sufficient to fulfill the Exchange's self-regulatory responsibilities.

Based on the foregoing, the Division recommends that:

- The Exchange should continue to take such ongoing steps as necessary to ensure that Market Regulation staff is increased appropriately whenever necessary in light of trading volume, products traded, futures and options industry changes, new responsibilities assigned to Market Regulation, or other relevant developments.

## V. AUDIT TRAIL PROGRAM

### Core Principle 10 – Trade Information:

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

### Core Principle 17 – Recordkeeping:

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

Pursuant to the acceptable practices set forth in Appendix B to Part 38 of the Commission's regulations, an effective contract market audit trail program should capture and retain sufficient trade-related information to permit contract market staff to detect trading abuses and to reconstruct transactions within a reasonable period of time. In addition, the contract market must create and maintain an electronic transaction history database that contains information with respect to transactions executed on the designated contract market. An acceptable audit trail also must be able to track a customer order from time of receipt through fill allocation or other disposition. Further, an acceptable audit trail should include original source documents, transaction history, electronic analysis capability, and safe storage capability.<sup>19</sup>

Original source documents include unalterable, sequentially identified records on which trade execution information is originally recorded, whether manually or electronically. A transaction history consists of an electronic history of each transaction, including all data that are input into the trade entry or matching system for the transaction to match and clear. These data should include the categories of participants for whom such trades are executed; timing and

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<sup>19</sup> The Division notes that this review does not contain any judgments with respect to the Exchange's compliance with the safe storage requirements found in Core Principle 10, *Trade Information*. The Division conducts separate examinations of DCMs' compliance with the safe storage requirements.

sequencing data adequate to reconstruct trading; and the identification of each account to which fills are allocated. An electronic analysis capability permits sorting and presenting data included in the transaction history so as to reconstruct trading and to identify possible trading violations, while safe storage capability provides for a method of storing the data included in the transaction history in a manner that protects the data from unauthorized alteration, accidental erasure, or other loss.

Commission Regulation 1.31 governs the manner in which an exchange is required to maintain trade-related records. The regulation mandates that all records required to be kept under the Act or Commission regulations be maintained for five years and be readily accessible during the first two years.

#### **A. NYMEX Globex Audit Trail**

##### **1. Audit Trail Creation And Contents**

Trading on Globex, CME's electronic trading system, now accounts for approximately 88 percent of all trades executed at NYMEX. There were approximately 482 million electronic messages entered per month in NYMEX products through the Globex system, which resulted in an average trading volume of approximately 26 million contracts per month during the target period.

During the target period, NYMEX transitioned its method of recording the Globex audit trail by moving from an end-of-day flat file called the "GAT" (Globex Audit Trail) to the RAPID system.<sup>20</sup> The RAPID system creates a comprehensive audit trail of electronic activity by receiving all order entry and system acknowledgment messages on Globex that are streamed via servers that are configured to "listen" for such messages on the CME's internal network. The

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<sup>20</sup> The RAPID system is described in more detail in Section VI(B)(2) of this report.

messages are recorded in real time in their raw state in the RAPID recorder function of the system, and this system is replicated in two different data centers. Another function of the RAPID system is to join inbound order messages with the Globex system acknowledgment messages to create a database record. This database record is then loaded live into an in-memory database application which users can access in real time. At least two years of archived data is readily accessible to users, and users can request that programmers load older dates beyond two years within one or two days. The retained information includes all orders, all order modifications, cancellations, replacements, all responses by the system to such messages, and all trades matched by the system. It also includes all mass quote messages submitted by market makers through CME Globex's mass quote functionality, which allows submission of two-sided bids and offers in multiple instruments within an entire product group in one message. The audit trail additionally includes the date and time of each message and each matched trade, recorded to the nearest millisecond. The system does not allow traders or exchange staff to erase or alter any message from the audit trail, whether it consists of an order, mass quote, order modification or cancellation, or trade match.

As noted above, the CME Globex audit trail includes both historical and live message and trade data. Approximately two years of data is immediately accessible online, through a new archive system that provides faster data access than the previous system. Data enters the database on a real time basis, and can be reviewed by Market Regulation staff up-to-the-minute, if desired. Historical data going back to 2006 can be accessed and viewed online within one or two days (depending on the volume of older data requested).

The audit trail data for each order includes the order's price, quantity, product (including the contract month and year), customer type indicator ("CTI") code, buy/sell indicator code,

exchange indicator code, guaranteeing clearing member code, order type (and order qualifier, stop price or trigger price, if applicable), account number, and, for options, a put or call indicator and strike price. All of this information must be entered into the system before CME Globex will accept an order. Each order carries a trader order number, assigned by the front-end system used by the trader entering the order, and a host order number, assigned by CME Globex upon receipt of the order. These numbers facilitate tracking the order's history within the trader's computer system and within CME Globex, respectively. For modified or cancelled orders, audit trail data includes a record of the nature of the modification or cancellation and the time at which it was made. For spread orders, audit trail data includes a spread ID, the spread type, and the number of legs in the spread. For executed orders, the data includes complete fill information with the details of the resulting trades.

## **2. Identification Of Order Sources**

Access to the CME Globex system requires a clearing firm guarantee and orders may be entered only through system interfaces that have been certified by the CME Group.<sup>21</sup> Each person who enters an order into CME Globex must have a workstation operator identifier, known as a Tag 50 ID, that is unique at the clearing firm and which identifies the individual operator, and is submitted on each order entered into the Globex system. The rules of the Exchange prohibit market participants from entering any message into the system under a Tag 50 ID other than their own, and from permitting any other individual to use another's Tag 50 ID.<sup>22</sup>

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<sup>21</sup> A variety of front-end applications are available from CME, FCMs, IBs, and independent software vendors ("ISVs"). Customers using a front-end system may connect to CME Globex over the Internet or through the network or data center of an FCM, IB or ISV. Customers who qualify for and execute a direct access agreement with CME Group may submit their orders directly into CME Globex through their own direct connection.

<sup>22</sup> Tag 50 IDs must be registered in the Exchange's fee system if they are assigned to individual Exchange members, employees of individual members, employees or contractors of a clearing or corporate member, or any other party whose trades receive preferential trading fees under NYMEX's fee programs. In addition, either the Globex Control Center ("GCC") or Market Regulation can require registration of the Tag 50 ID of any other market participant,



Each Automated Trading System (“ATS”) that generates and routes an order to CME Globex must be submitted with a unique Tag 50 ID that identifies the person or persons who operate and/or administer the ATS. If multiple individuals work together simultaneously to operate the ATS, they would be able to operate as an “ATS Team” that is assigned a single Tag 50 ID.<sup>23</sup> This is the only situation in which the Exchange permits more than one individual to be associated with the same Tag 50 ID. Where a single ATS Operator or an ATS Team may be responsible for multiple trading models, algorithms, programs, or systems that trade the same product and potentially could trade opposite one another, then each such model, algorithm, program, or system must be assigned a separate Tag 50 ID.

### **3. Identification Of Account Owners**

Market Regulation can identify the owner of the account whose number is attached to a given Globex or open outcry order in one of four ways. First, the Exchange’s fee system maintains a record of the identity of the owner or owners of each trading account registered in the fee system in order to obtain discounted trading fees. Second, the Exchange’s Large Trader System stores CFTC Form 102 data which identifies the controllers and/or owners of holders of reportable positions.<sup>24</sup> In 2010, Market Regulation implemented a program that relates reportable accounts in the Exchange’s new Large Trader System (“LTS”) to corresponding

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something typically required when a participant generates significant messaging traffic. Prior to the merger, Tag 50 IDs were required by NYMEX for trades executed on CME Globex, but were not registered with the Exchange.

<sup>23</sup> For example, an ATS Team Tag 50 ID could be assigned where one firm employee may adjust pricing parameters, while another continuously monitors positions or risk or adjusts trade size parameters. ATS Team Tag 50 IDs are permitted only in true team situations where multiple operators operate the same ATS at the same time. Team Tag 50 IDs are not allowed for operators that are primarily responsible for different ATSs, or operators who control the same ATS on different shifts.

<sup>24</sup> CFTC Form 102 is used by clearing members, FCMs, and foreign brokers to report to the Commission on a daily basis, as required by Commission regulations, the futures and options positions of each trader holding positions at or above reporting levels set by the Commission for each commodity under its jurisdiction.

identified trading accounts via a Market Participant Identifier. This makes account owner information visible to staff investigators who are using either LTS or the Sophisticated Market Analysis Research Technology (“SMART”)<sup>25</sup> system to conduct trade practice surveillance. Third, if an account trades large volume during the trading day and is of interest to Market Regulation but is not otherwise identified in the fee system or in LTS, Market Regulation will call the clearing member that guarantees the account to identify the account owner and include that information in its systems. For accounts not identified by any of the above three methods, Market Regulation can obtain the identity of the owner or owners of an account, if necessary, by calling the clearing member that guarantees the account. The Exchange maintains all collected account ownership information in LTS and reports that through these account identification methods it can identify owners for approximately 85 percent of trading volume.

#### **4. Pre-Host Audit Trail Data**

In addition to the audit trail data recorded and maintained in the CME Globex database, the Exchange also requires each clearing member to maintain or cause its customers to maintain for five years a complete order-routing, front-end audit trail for all electronic orders entered into CME Globex through iLink,<sup>26</sup> CME’s wide area network, by that clearing member or its customers.<sup>27</sup> The clearing member must be able to produce this audit trail data in a standard format to Market Regulation upon request. In addition to a complete record of all messages

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<sup>25</sup> The SMART system is described in more detail in Section VI(B)(1) of this report.

<sup>26</sup> The audit trail for each message sent to CME Globex via iLink includes codes identifying both the server that hosts the iLink connection, and the particular instance or session of iLink (if any) within it, from which the message originated. Firms often set up a separate instance or session of iLink for the use of a particular customer or of a particular trading desk within the firm. The session ID attached to messages originating in a particular session enables RAPID tracking of the messages transmitted by that customer or trading desk.

<sup>27</sup> NYMEX Rule 536(B) (2). The Exchanges impose this requirement pursuant to the Commission’s Advisory, *Alternative Method of Compliance With the Written Record Requirements*, 62 Fed. Reg. 7675 (Feb. 20, 1997).

transmitted to CME Globex, the audit trail so maintained must include a record of all orders that were placed but rejected for any reason either by the order routing system or by CME Globex.

## **B. Review Of Compliance With CME Globex Audit Trail Requirements**

Review of trader compliance with both electronic and open outcry audit trail and recordkeeping requirements was conducted by NYMEX staff during the target period. However, as noted above, Market Regulation's Data Quality Assurance Group in Chicago now performs the Globex data assurance program for the Exchange.

During the target period, Market Regulation refocused and reorganized its program for review of compliance with electronic audit trail requirements. Market Regulation now conducts annual "Globex audits" of recordkeeping in electronic trading for the Exchange's clearing members. The principal component of the audit consists of staff review of CME Globex electronic audit trail data for trading guaranteed by the clearing member, using data analysis tools developed by Market Regulation to audit the accuracy and practices of clearing firms with respect to certain recordkeeping requirements relating to Tag 50 IDs, CTI codes, and account numbers.

To examine Tag 50 ID requirements, analysts select a period of time for examination, typically two to three months of trading, and aggregate orders entered during that period under selected Tag 50 IDs or for selected account numbers.<sup>28</sup> Next, analysts review the orders associated with individual IDs or account numbers for trading patterns that may indicate either audit trail errors or possible violations of electronic audit trail rules concerning the use of Tag 50 IDs, account numbers, and CTI codes.

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<sup>28</sup> Prior to the target period, such aggregation was only possible through exporting audit trail data into an Excel spreadsheet, a slower and more labor-intensive process.

To monitor and detect improper use of CTI codes and account numbers, analysts use various compliance exception reports to isolate possible instances, including trading on behalf of a single account which includes orders bearing different CTI codes and irregular CTI code combinations.<sup>29</sup> While it can be normal for trading on behalf of a single account to include orders coded CTI 1 (individual member for himself) and CTI 3 (individual member on behalf of another individual member), trading for one account that involved both orders coded CTI 2 (orders for a proprietary account of a member firm) and orders coded CTI 4 (orders entered on behalf of a non-member market participant) would indicate possible audit trail errors or data accuracy issues.<sup>30</sup>

To examine electronic audit trail requirements concerning usage of account numbers, analysts review account number corrections made by firms both before and after trade clearing. In the course of their review of account number changes, analysts also monitor compliance with the Exchange's rules relating to give-ups and use of suspense accounts, requesting relevant records to verify that required information and timestamps are present for all stages of such transactions.

Although review of front-end audit trail data is no longer the principal focus of the electronic audit trail compliance program, staff continues to review front-end audit trail data from each new front-end system used to submit orders to CME Globex when the system first goes into use, to ensure that the system is saving all required audit trail data as required by the

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<sup>29</sup> For electronic trading at CME Group exchanges, CTI codes have the following meanings. CTI 1 indicates a transaction by an individual member for his or her own account, an account he or she controls, or an account in which he or she has an ownership or financial interest. CTI 2 denotes a transaction for a proprietary account of a member firm. CTI 3 designates an order entered by a member or non-member terminal operator for an account owned or controlled by another individual member. CTI 4 applies to transactions not covered by the other codes, and typically denotes an order entered by or on behalf of a non-member. See NYMEX Rule 536D.

<sup>30</sup> Other anomalous CTI code combinations that would require additional review include trading for a single account that included orders coded both CTI 1 and CTI 2, or orders coded both CTI 1 and CTI 4.

Exchange. Additionally, firms are requested to certify that the required audit trail data is being saved for all of their guaranteed connections.

One additional component of the audit trail for a very small number of CME Globex orders is comprised of paper order tickets. The Exchange's rules require that customer orders for CME Globex trading that are telephoned to an FCM or IB must be immediately entered into CME Globex upon receipt if the orders are capable of being entered when they are received. If a customer order cannot be immediately entered into CME Globex, the account designation, order details, date, and time the order was received must be recorded on a written order ticket. The order must then be entered into CME Globex when it becomes executable. During back office audits of clearing members, Market Regulation reviews samples of any paper order tickets for CME Globex orders prepared by the firm. No deficiencies with respect to such order tickets were found during the audits conducted during the target period.

During the target period, staff conducted 17 Globex audits covering 16 clearing members. Of the 17 audits, Market Regulation staff closed nine audits that were initiated prior to the start of the target period. Six of the eight audits opened during the target period also closed during the target period. One of the audits that remained open at the conclusion of the target period has since closed.

In eight of the audits, staff identified audit trail issues ranging from incorrect CTI codes, problems with correct Tag 50 ID transmission, incorrect configuration or use of Tag 50 IDs, failure to register Tag 50 IDs as ATS IDs and sharing of Tag 50 IDs. In seven audits, no issues were identified. Market Regulation issued a pair of warning letters to one clearing firm for sharing the same Tag 50 IDs and failure to properly register ATS Tag 50 IDs. Advisory letters were issued to five different clearing members after Market Regulation identified missing

information in the firm's electronic front-end audit trail, including expiration months for spread messages, trader order number, and client order IDs.<sup>31</sup>

## **C. Open Outcry Audit Trail**

### **1. Introduction**

All Exchange members, member firms, and their employees must keep full, complete and systematic records, including records created or transmitted electronically, of all transactions relating to the business of dealing in commodity futures, options, and cash transactions; retain such records for a minimum of five years; and make them available to Market Regulation or the Commission on request, in accordance with Commission Regulation §1.35. This includes retention of order ticket originals by clearing members and of duplicate copies by floor traders.

### **2. Electronic Audit Trail For Open Outcry Orders**

Floor brokers receive electronic open outcry orders by email, instant message, or other similar means. Trades must be recorded in the exact sequence in which they were executed, and the time for each trade must be entered. An electronic trading pad "tablet" that is approved for use by the Exchange can be used for recordation of such trades and side-by-side trading. Option floor traders, primarily locals, record their trades electronically using a screen based trading card system called "WhenTech." A printed record of the trading recorded on WhenTech is required to be retained by the floor traders.

Audit trail data concerning all open outcry trades was entered in the Trade Management System ("TMS") through fall 2009 and thereafter through the CME Front End Clearing system. The cleared data is also available on the Exchange's SMART system.

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<sup>31</sup> An advisory letter reminds a market participant of Exchange rule provisions that may apply to the participant's conduct and places the participant on notice that the Exchange views certain actions as potential rule violations. Unlike warning letters, advisory letters do not become part of the participant's disciplinary record considered by disciplinary committees in subsequent proceedings.

Exchange rules allow the use of headsets on the trading floor. Headset communications must be voice recorded by the member or member firm authorized to use the headset, and all such recordings must be maintained.<sup>32</sup> There are approximately 120 headsets on the trading floor. Additionally, Exchange rules require each member and member firm to enter into a trading floor subscriber agreement with the Exchange under which the subscriber agrees to pay the Exchange to record and archive all conversations conducted on their Exchange floor telephone lines.<sup>33</sup> The recordings are maintained by the Exchange for a minimum period of 10 business days following the day when such recordings are made.

### **3. Paper Audit Trail For Open Outcry Orders**

The Exchange maintains a traditional paper audit trail for orders transmitted to the pit via flashed hand signals, verbal transmission over floor broker headsets, email or instant messaging, or physical delivery of paper order tickets. The relative proportion of orders sent to floor brokers in these different ways varies with the product involved. When an open outcry order arrives on the floor, whether by telephone, email, instant message, or other similar means, or is received directly by a floor broker over a headset, the terms of the order and the account identifier must be recorded on a paper order ticket in non-erasable ink.

The order terms required to be recorded include the order's date, product, expiration month, quantity, price, and for options, a put or call indicator and strike price. Order tickets must also record an account identifier for the account for which the order was placed.<sup>34</sup> Order tickets must be timestamped immediately when the order is received on the floor ("entry time") and

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<sup>32</sup> NYMEX Rule 506.

<sup>33</sup> NYMEX Rule 536G.

<sup>34</sup> A customer account number is not required at the time of execution for bunched orders entered by eligible account managers for accounts eligible for post-trade allocation, provided that such orders are allocated and recorded in accordance with Commission Regulation 1.35(a-1)(5).

timestamped again when the fill is reported to the customer (“exit time”) or when the order is modified or cancelled.

Trades must be recorded in non-erasable ink on a single-sided trading card which contains a pre-printed sequence number and the floor member’s trading symbol. All transactions on the card must be recorded in the order in which they were executed. The floor member may not skip any lines, and must cross out any unused lines before starting a new card. Erroneous information may be crossed out, but may not be obliterated. No more than nine transactions may be recorded on a single card, and a new trading card must be used at the start of each 30-minute time bracket and at the start of the post settlement session.

The trade data required to be recorded on trading cards includes the date, price, quantity, commodity, and contract month of the trade, the time of execution of the trade, the executing member’s name or symbol, the identity of the opposite member, and a symbol indicating whether the trade was executed for the member’s account, for the proprietary account of their clearing member, for another member present on the trading floor or for any other account. Options trades must also include the strike price, put or call indicator, and expiration month. Trading cards must be turned in for collection within 15 minutes of the end of the half-hour period during which the cards were used.

#### **4. One Minute Timing Compliance**

All Exchange trading is monitored for compliance with the requirement that floor traders record the time of each trade to the nearest minute. During most of the target period, Market Regulation monitored trade timing compliance by all open outcry traders through regular review of computerized recordkeeping exception reports generated by the NYMEX TPY2K system, including the Pit Card Trade Time Validation report. The Pit Card Trade Time Validation report compares timing indicia with prices captured and posted on the Price Change Register (“PCR”)



in order to assess the accuracy of each member's trade timing. The traded price must be quoted, posted, or have an active prevailing price in the PCR for the traded instrument during a three minute period (one-minute prior to execution time, the minute of the execution time, and the minute after the execution time). Additionally, the report generates a summary that includes each member's total number of trades and overall accuracy level along with a percentage for each member during the month. The reviews conducted by Market Regulation during the target period to assess the accuracy of the one-minute timing requirement resulted in the issuance of 26 warning letters and no fines to NYMEX members, and no warnings or fines to COMEX members.

By the end of 2009, Market Regulation was using the Trade Timing Algorithm ("TTA") system developed by CME Group to impute execution times for open outcry trades.<sup>35</sup> The new TTA system, which runs on state-of-the-art computer technology, uses seller and buyer recorded execution times from the pit cards, along with time and sales information, to impute execution times for all open outcry trades. From the trader recorded execution times for both the buy and sell side for each trade, TTA constructs timing windows using the relevant "start" and "end" times based on the minute before the execution time, the minute of the execution time, and the minute after the execution time for both buyer and seller, and compares these windows to narrow the timeframe during which a trade could have occurred. Based on the narrowest timing window that can be constructed and the intersection of the time of the prevailing quote, the system then assigns an imputed execution time to the trade. The system imputes a trade time even for trades

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<sup>35</sup> A separate Spread Grouping Algorithm ("SGA") system, associated with TTA, creates imputed trade times for open outcry spread transactions. The TTA and SGA applications are both back-end components of the SMART system, which is the successor to the former TPY2K system.

without a corresponding price quote, based on analysis of both trader recorded execution times. Market Regulation uses TTA execution times and the trade data collected from floor trading documents to reconstruct open outcry trading activity and conduct trade practice surveillance with respect to open outcry trading. Because the accuracy and efficacy of this process depends on proper recordation of trade data by floor members, Market Regulation conducts routine audit trail reviews to monitor compliance with Exchange open outcry recordkeeping rules.

## **5. Recordingkeeping: Compliance with Trading Cards and Order Tickets Requirements**

### **a. Trading Cards**

To evaluate and enforce members' compliance with the Exchange's trading card recordkeeping requirements, Market Regulation conducts an annual review of three days of original trading cards for each floor member and administers a summary disciplinary program. Based upon levels of compliance with eight categories of requirements included in a Market Regulation checklist, members are determined to be in "Full Compliance," "Effective Compliance," or "Not in Compliance."<sup>36</sup>

A member with no discrepancies in any of the eight categories would be in Full Compliance, a member with a compliance rate of 90 percent or better in categories one through three, no more than two violations in category four, and no discrepancies in categories five through eight, would be in Effective Compliance, and a member who failed to meet these standards would be deemed Not in Compliance. Members found to be in the latter category are subject to disciplinary action. In 2011, NYMEX increased the summary fine schedule for audit

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<sup>36</sup> The eight categories of requirements include (1) time of execution of each trade; (2) identification of the open or close and marking through unused lines; (3) buys and sells recorded sequentially in chronological order without skipping lines or sharing lines; (4) drawing a single line through erroneous information; (5) using non-erasable ink; (6) cards maintained by the floor member; (7) cards are used in numerical sequence day-to-day; and (8) cards that are not used, or are rewritten by the floor member, are maintained.

trail violations. Under the Exchange's summary fine schedule, audit trail violations within a rolling 12-month period result in the issuance of a warning letter for the first offense, a fine of \$1,000 for the second offense, a \$2,500 fine for the third offense, and a \$5,000 fine for the fourth offense. A fifth offense within the rolling 12-month period results in the automatic referral to the Probable Cause Committee ("PCC") for the consideration of the issuance of charges.

During the target period, the Exchange conducted 200 reviews of 186 active open outcry traders for recordkeeping compliance. Market Regulation reviewed 5,742 trading cards and identified 603 trading cards with violations, and issued 40 warning letters. Thus, 20 percent of the trading card reviews resulted in the issuance of warning letters. There were no summary fines issued for trading card reviews during the target period. Therefore, 80 percent of these reviews had no recordkeeping infractions meriting summary fines or warning letters. No traders were referred to the PCC for disciplinary action concerning recordkeeping offenses.

#### **b. Order Tickets**

To evaluate member compliance with the Exchange's order ticket recordkeeping requirements, Market Regulation conducts floor and branch order ticket reviews and reviews order tickets during the course of trade practice investigations.

Every month, the floor order ticket review program results in the opening of either five NYMEX or five COMEX reviews of broker groups or independent members. Floor order ticket reviews are alternated monthly between NYMEX and COMEX members. Typically, an analyst is assigned either five NYMEX or five COMEX groups for a monthly floor order ticket review. The analyst requests all floor order tickets prepared by the selected broker groups or independent members on selected days during the month in order to ensure that the appropriate number of order tickets required for the review are received. The analyst then randomly selects a sample of 20 floor orders tickets from each of the floor groups or independent members under examination

including, when possible, unfilled order tickets and a sample of orders executed by each member of a broker group. The floor order tickets selected are examined for, among other things, the required account identification and timestamps. All filled or partially filled orders are required to have entry and exit timestamps; unfilled or canceled orders are required to have at least the entry timestamp; and orders for which the terms have changed are required to have a timestamp which corresponds to the change. Broker groups or independent members might also be selected for review based upon the appearance of the orders tickets examined during the course of an investigation.

For each branch audit, staff selects an FCM to review based on failing prior reviews, rotational review selection, and FCMs that generate order tickets. Staff reviews the information on the order tickets and also compares the information to the corresponding floor documentation. FCMs found not to be in compliance with recordkeeping requirements are subject to disciplinary sanctions. A finding of 90 percent or better compliance results in no action. Compliance rates of less than 90 percent, in either the first, second or third review, may result in the imposition of summary fines.<sup>37</sup> Fourth and subsequent violations within a twenty-four month period time may result in a referral to the PCC for the issuance of charges.

During the target period, Market Regulation examined 436 floor order tickets from a total of 74 floor brokers and 40 selected groups. Eighty-five percent of the order tickets passed, 14.6 percent were found to have time stamping errors, and 6.6 percent had account identification

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<sup>37</sup> Under the Exchange's summary fine schedule for order ticket violations, Market Regulation may impose fines corresponding to the following rates of compliance: (1) 89 to 80 percent - \$500, (2) 79 to 70 percent - \$1,000, (3) 69 to 60 percent \$1,500, and (4) 59 percent and below - \$2,500. If after a second review an entity fails to achieve a passing compliance rate, Market Regulation may impose fines corresponding to the following rates of compliance: (1) 89 to 80 percent - \$1,000, (2) 79 to 70 percent, \$2,000, (3) 69 to 60 percent - \$3,000, and (4) 59 percent and below - \$5,000. If after a third, or any subsequent review, an entity fails to achieve a passing compliance rate, Market Regulation may impose fines corresponding to the following rates of compliance: (1) 89 to 80 percent - \$2,500, (2) 79 to 70 percent - \$5,000, (3) 69 to 60 percent - \$7,500, and (4) 59 percent and below - \$10,000.

errors. Summary fines totaled \$4,700 for timestamping errors and \$1,200 for account identifications errors. No firms were referred to the PCC for recordkeeping-related disciplinary action.

During the target period Market Regulation conducted order ticket reviews for three firms. These reviews indicated generally high rates of firm compliance with Exchange recordkeeping requirements. Market Regulation informed the Division that the number of firm order ticket reviews was limited by the number of firms that generate such order tickets. The shift to electronic trading has eliminated the use of such order tickets at most firms.

#### **D. Conclusions And Recommendations**

The Division found that NYMEX maintains an adequate audit trail program. The audit trail maintained by the Exchange records trade data in a manner that enables it to identify customer and market abuses and provide evidence of rule violations. With respect to electronic trading on CME Globex, which now accounts for approximately 88 percent of the Exchange's total volume, the audit trail is captured and retained in an electronic record which includes all messages entered into or sent by CME Globex, the terms and time of entry for each order, all order modifications, and all matched trades. The system does not allow traders or exchange staff to alter or erase any message in the audit trail. The audit trail includes identification of the source of each order, and enables Market Regulation to readily identify the owner of the account for whom each order is submitted. This record allows Market Regulation staff to reconstruct CME Globex trading efficiently and effectively. Market Regulation conducts annual Globex audits of trader and firm compliance with electronic recordkeeping requirements. Finally, the Exchange maintains a traditional paper audit trail for open outcry orders transmitted to the pit by headset, flashed hand signals, physical delivery of order tickets, or electronic order routing, and

monitors individual member and member firm compliance with recordkeeping rules through routine audit trail reviews which result in detection and sanctioning of recordkeeping violations.

Based on the foregoing, the Division has no recommendations.

## VI. TRADE PRACTICE SURVEILLANCE PROGRAM

### Core Principle 2 – Compliance with Rules:

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

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

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

Pursuant to Appendix B to Part 38 of the Commission's regulations, a contract market's trade practice surveillance program should have the arrangements, resources, and authority necessary to perform effective rule enforcement. The arrangements and resources attendant to the program should facilitate the direct supervision of the contract market, including analysis of relevant data. Trade practice surveillance programs can be carried out by the contract market itself or through delegation to a third party.

An acceptable program should have systems that maintain all data reflecting the details of each transaction executed on the contract market. In this regard, the program should include routine electronic analysis of these data to detect potential trading violations. The program also should provide for appropriate and thorough investigation of all potential trading violations brought to the contract market's attention, including member and Commission referrals and customer complaints. In addition, the program should have the authority to discipline, suspend, or terminate the activities of members or market participants pursuant to clear and fair standards.<sup>38</sup>

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<sup>38</sup> The aspect of Core Principle 2 that relates to the disciplining of members who violate Exchange rules is discussed below in Section VII. This section of the report addresses the Exchange's program for monitoring their markets for possible trading abuses and the investigation of any identified abuses.

## **A. Staffing And Division Of Trade Practice Surveillance Duties**

As discussed above, Market Regulation's Investigations Group, which consists of 14 New York-based employees who oversee the NYMEX and COMEX markets, is an experienced staff and responsible for conducting trade practice surveillance and investigations for the Exchange. The 14 employees include the Director of Market Regulation, an Associate Director of Market Regulation, 11 investigators at various levels, and an administrative assistant. The Director of Market Regulation, who reports to the Director of Global Market Investigations in Chicago, heads the Investigations Group in New York.

All investigators are involved in at least two of the three principal tasks of the trade practice surveillance program, namely trade practice "research" and trade practice "investigations." Some are also included in specialized trade practice programs designed to detect particular types of major trade practice violations, as discussed below.

Research (sometimes called trade practice surveillance) consists of regular review or data mining of trade data across both NYMEX and COMEX, using Market Regulation's sophisticated computerized surveillance tools, to detect patterns of trading activity that could indicate possible trading violations and merit further investigation. While research may still include review of pertinent, pre-determined exception reports, its major focus is on customized, ad hoc queries that focus on particular markets, time frames, firms, participants, trade sequences, or other aspects of trading activity.

Each investigator also participates in investigations (sometimes referred to as casework). Investigations are initiated whenever research, a customer or trader complaint, or a Commission referral indicates the possibility of a violation of Exchange rules or of the Act or Commission regulations. Investigators are frequently assigned to investigations involving products belonging to the particular research group in which they are working.



Some investigators are also assigned on a rotating basis to one of five specialized structured surveillance programs aimed at detection of specific types of trade practice violations where pattern matching is fairly clear-cut, including wash trading, improper cross trading, trading ahead of customer orders, improper assignment of trades, and money pass transactions. Based on its experience in detecting and prosecuting these major violation types, Market Regulation has developed specific computerized pattern detection tools and methods of data analysis to identify trading patterns that can indicate that such violations are occurring.<sup>39</sup> Investigators initially run the computerized exception reports developed for the program with broadly set parameters, to help ensure that possible violations are not missed. They can then narrow the parameters if desired, in order to focus in on particular trades or market participants.

## **B. Automated Surveillance**

Market Regulation currently uses a combination of three systems to detect and investigate trade practice violations for both electronic and open outcry trading, including the SMART

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<sup>39</sup> The “wash trading program” identifies instances where both sides of a transaction are placed for the same account. It includes detection of ATS trading activity that could constitute wash trading, since market participants who use such systems to enter orders on opposite sides of a market that could cross with each other are responsible for employing algorithmic functionality designed to minimize or eliminate instances where their buy and sell orders match with each other. Investigators in the “trading ahead program” use a variety of Market Regulation’s surveillance tools to monitor the relationships between a floor broker’s personal trades and their execution of customer orders in the same contract. The “assignment trade program” reviews assignment trades for possible violations of Exchange assignment trade rules. The “cross trading program” reviews electronic trading to identify cross trades that do not fit within the requirements of Exchange rules restricting cross trades to narrowly defined circumstances in which various requirements, such as use of a Request for Quote prior to crossing option orders on Globex, are met. In May 2011, Market Regulation developed an ad hoc, configurable database that allows investigators in the “money pass program” to monitor paired, round-turn transactions between counterparties that may have been executed for the purpose of transferring funds between accounts.

system, the RAPID system, and the Exchange's Large Trader System (known as LTS).<sup>40</sup>

Transition by the NYMEX staff to the current automated systems began in September 2008, when access was gained to the RAPID system, and continued throughout the target period, with the transition to LTS occurring in September 2009 and migration to SMART occurring in October 2009.<sup>41</sup>

### **1. Sophisticated Market Analysis Research Technology**

The SMART system brings together for investigators all cleared trade and quotation data for both the electronic and open outcry venues at the Exchange. The system also includes audit trails of the electronic order routing systems used on exchange trading floors, as well as cleared trade and allocation data from the clearing system.

SMART's analysis functions allow investigators to repeat research techniques and strategies that have proved fruitful in the past, and give access to resulting exception reports or pattern matches concerning major violation types such as wash trading, money pass, directly or indirectly taking the other side of a customer order, improper cross trading, and trading ahead of customer orders, among others. A new exception report incorporated as a result of the NYMEX integration is the Trading at Settlement ("TAS") closing manipulation module, which identifies instances of traders accumulating sizable positions in a TAS contract during the day, slowly

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<sup>40</sup> The LTS system combines the previous Large Trader systems of CBOT, CME, and NYMEX. While the LTS system is used extensively for market surveillance (which is not covered in this review), it is an important tool for investigators conducting trade practice surveillance. The system gives investigators access to the daily reports submitted by clearing members concerning all market participants who own, control, or carry positions reportable under the Act and Commission regulations, including identified market participants and the account numbers of such participants. COMEX and NYMEX migrated to the new LTS system in September and October 2009, respectively, as they were integrated into the CME Group clearing system.

<sup>41</sup> Prior to the transition to the current suite of systems, staff utilized TXN, TPY2K, and Profile Analysis Workstation III, the NYMEX's legacy computerized surveillance programs, Large Trader, and a series of ad hoc pattern based exception identification programs for detecting and investigating trade practice violations. The legacy systems ran in parallel during the migration to the current automated trade systems until their decommission on March 12, 2010. While no new data is loaded into the legacy programs, the systems will remain online for five years from the date of decommission to review historical trade activity for ongoing investigations.

offsetting part of the position prior to the close, and then buying or selling the remaining TAS quantity in the closing period in an attempt to manipulate where the contract settles.

SMART's summarization functionality allows investigators to easily create trading profiles for accounts, traders or firms, and profiles of normal activity for particular markets. These are useful to investigators for identifying deviations from normal activity. Market profiles can be also used to identify periods when particular market conditions existed, *e.g.*, uptrends or downtrends, rallies, declines, fast markets, and to examine particular trader activity during such conditions. The latest profile, "volumetric," implemented as a result of the NYMEX integration, allows an investigator to examine trade data from four different perspectives—by market participant, firm, Tag 50 ID, and open outcry traders. The profile shows what percentage of the market each entity represents during the selected time frame, ranking them from greatest to smallest, and maintains a running cumulative total of the percentages.

## **2. RAPID**

The RAPID system takes data directly from the CME Globex trading engine, allowing Market Regulation to view all Globex order and trade messages on a real time or historical basis. RAPID can also quickly take the stored messages and reconstruct the order book in an instrument for a given time. RAPID's Armada module allows staff to view the three to 10-deep published order book in any Globex product in near real time or historically. In addition, RAPID's "live alert" functionality monitors intraday trading positions on Globex, compares them with position thresholds set by Market Regulation for each product and to the 50-day moving average of position size for each account, and alerts Market Regulation staff if an individual account's position exceeds a product threshold or is unusual for that account. Market Regulation developed additional RAPID tools, including alerts for situations where trading for

an account involves unusually high volume regardless of position size and a replay feature that allows investigators to replay the market in real time or slow motion.

RAPID's capabilities allow staff to proactively monitor electronic trading and address potential problems as they occur. For example, if staff knows that an economic report is due to be released that could affect the markets, they can use RAPID to monitor electronic trading activity immediately before and after the report is released. RAPID also facilitates prompt resolution of questions and complaints regarding CME Globex trading.

### **C. Video And Floor Surveillance Of Open Outcry Trading**

There was no video surveillance on NYMEX or COMEX at the time of the Division's 2004 Review. When video surveillance was instituted in April 2006 for all trading rings, all cameras were ceiling mounted. In May 2009, with the consolidation of the NYMEX and COMEX trading rings, the locations of the cameras were changed to improve the overall coverage of the trading floor.

There are currently 30 cameras covering the trading floor. Fourteen are ceiling mounted, while others are mounted on the walls and trading stations. They are concealed by smoked domes so members cannot see which direction the cameras are pointing or focused, although the members know the location of the camera. The cameras are on during the entire trading session, pointed at strategic locations, which can be adjusted on demand. If an apparent violation occurs, the videotapes can be reviewed and used as evidence to improve or enhance an investigation. Video is typically saved and available to staff for three to four months. If video is being used for an investigation, it is copied onto a DVD. Although there is no audio component to video surveillance, since February 2009, audio recording of members' trading floor phone lines has

been mandatory.<sup>42</sup> Audio recordings are retained for a minimum of 10 days. Although captured separately, video and audio can be reviewed together to form a more complete picture of trading activity.

All investigators are required to spend time on the trading floor each month, in order to enhance Market Regulation's presence on the floor and to add to the investigators' knowledge of trading. At least one staff investigator is present on the trading floor to conduct surveillance during the opening and closing periods as well as the post-settlement sessions at the Exchange. When staff present on the floor observe activity that could indicate possible violations, they pass their observations to a manager or other appropriate person in Market Regulation. The information is then evaluated by the manager and may lead to a repositioning of recorded camera views and a review of relevant trade data.

#### **D. Trade Practice Investigations**

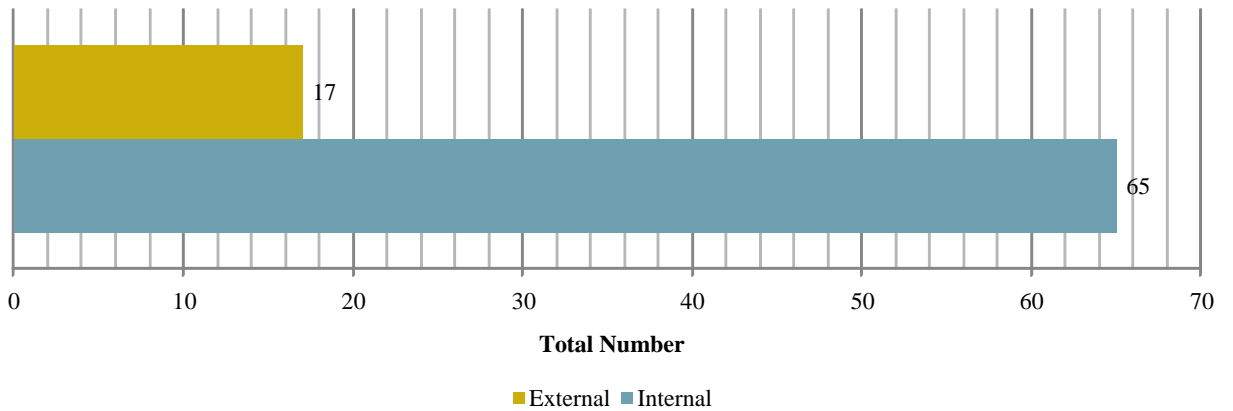
##### **1. Number of Investigations During the Target Period**

As seen in Figure 6 below, NYMEX opened 82 trade practice investigations ("TPIs" or "investigations") during the target period.

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<sup>42</sup> See Section V(C)(2) of this report for additional discussion concerning the mandatory recording of telephone lines.

**Figure 6– Number of Trade Practice Investigations Opened During the Target Period**



**Internally from the Exchange’s surveillancesystems– 65 TPIs**

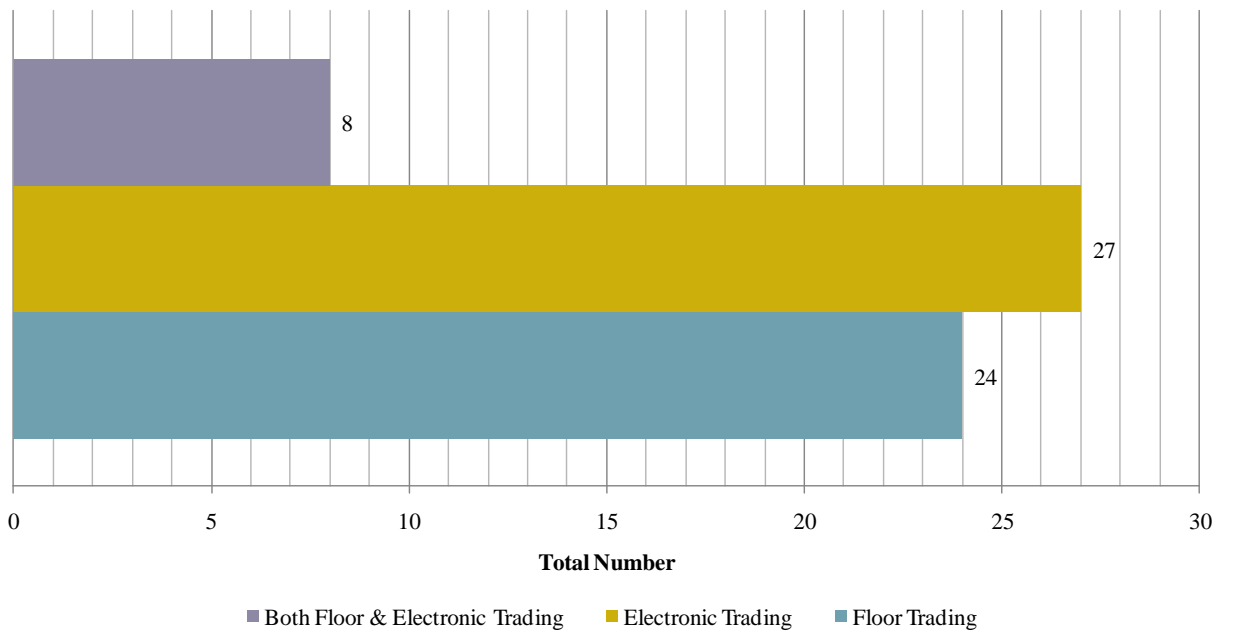
- exception reports (62- including 27 wash trading and 9 trading ahead)
- block trade reviews (1)
- floor surveillance (2)

**Externally from various sources – 17 TPIs**

- customers & members (9)
- CFTC (7)
- another regulatory body (1)

As shown below in Figure 7, NYMEX closed a total of 59 TPIs during the target period, including 28 that were both opened and closed during the target period.

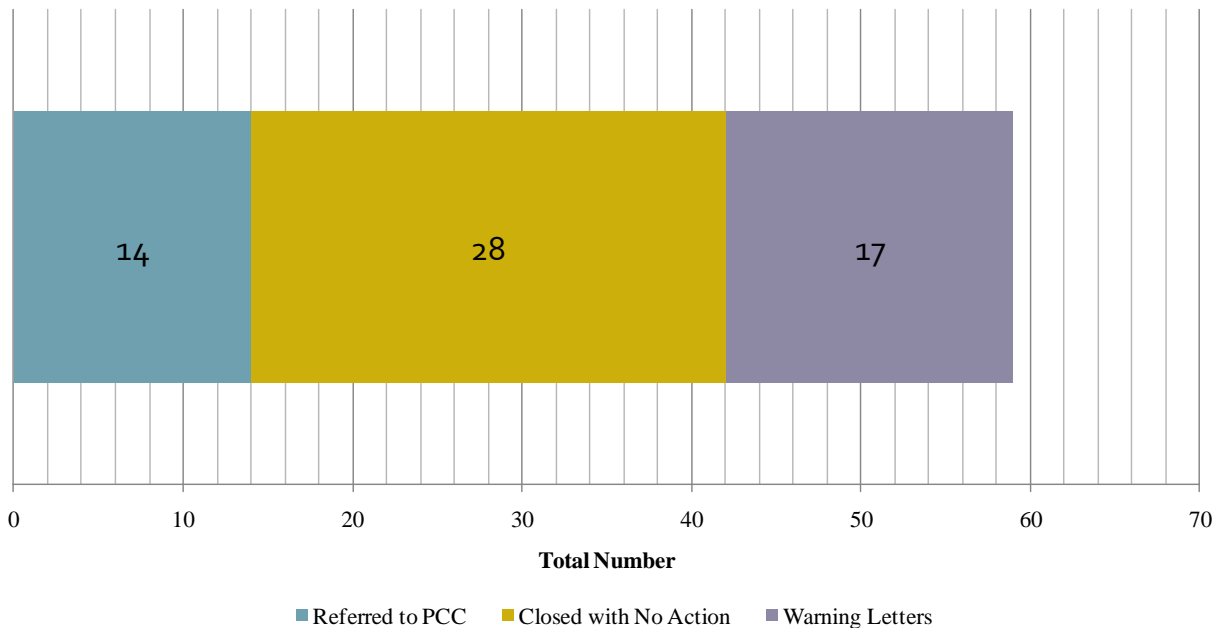
**Figure 7 – Trading Venue of the 59 Closed Investigations**



## 2. Adequacy of Investigations

The Division reviewed all 59 closed investigations for timeliness, adequacy, and documentation.<sup>43</sup> Figure 8 below provides the disposition of the 59 closed investigations.<sup>44</sup>

Figure 8 – Disposition of 59 Closed Investigations



The Division found that NYMEX’s investigation files were typically well-documented and included pertinent underlying trading documents, correspondence, computer reports, tape recordings of witness interviews, and summaries of the trading activity examined. Many investigation files included references to video surveillance. When necessary, investigations were broadened in scope to look for patterns of violations. Investigations that were closed with no further action included a close-out memorandum that typically contained a brief description of the investigation conducted and sufficient information for Division staff to make an informed

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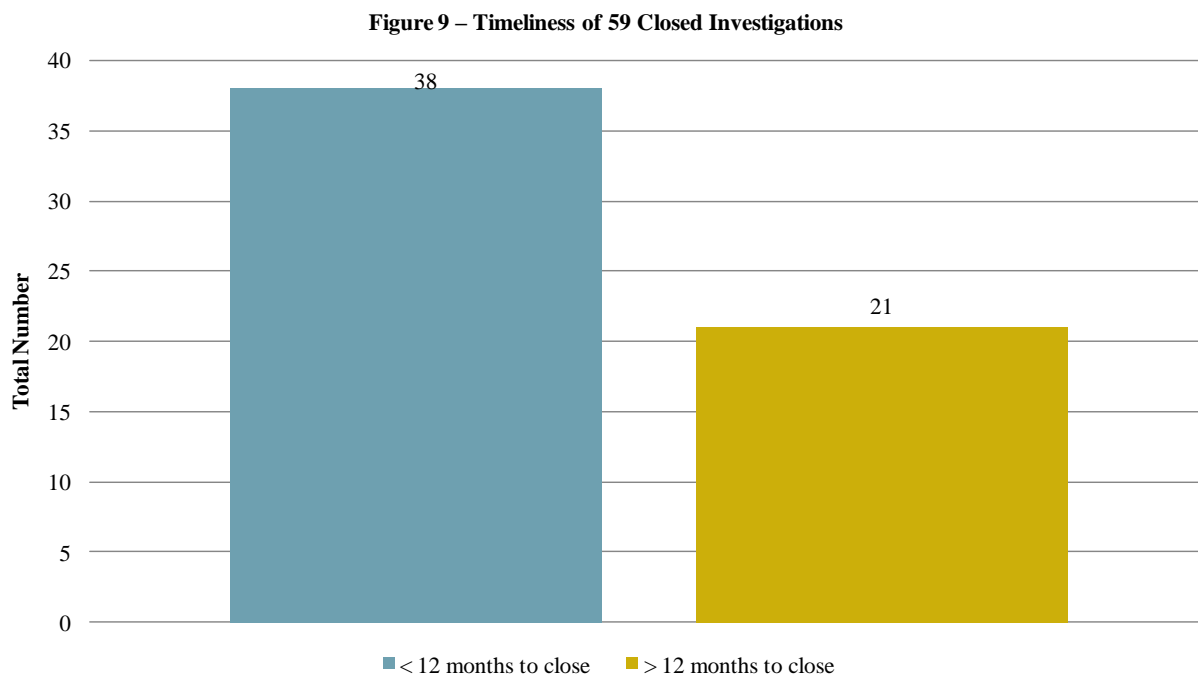
<sup>43</sup> During the target period, NYMEX also opened and closed 29 trade practice inquiries. Twenty-five were closed without further action. Three were elevated to investigation status, while one resulted in the issuance of advisory letters. The Division reviewed all closed inquiries and found that the conduct and resolution of the inquiries was adequate.

<sup>44</sup> Disciplinary cases are discussed separately in Section VII of this report.

decision regarding the adequacy of the investigation. Files for investigations that were referred for formal disciplinary action included an investigation report and a memorandum containing recommendations with respect to charges. Investigation reports described the details surrounding investigations, including how the matter was initiated, the facts developed during the course of the investigation, summaries of interviews, and Market Regulation staff's analysis and conclusions. Relevant computer reports were typically attached. In sum, the Division is satisfied that NYMEX conducts thorough investigations that include appropriate analysis.

### 3. Timeliness of Investigations

As indicated below in Figure 9, of the 59 TPIs that closed during the target period, 21 had been open for longer than one year.



Division staff examined all of the 21 closed investigations in detail to determine whether there was any apparent justification for their prolonged open periods. Staff also evaluated 11 investigations opened prior to the target period that were still open when the target period ended, for time periods ranging from 402 days to 1,378 days, for the same purpose.



Division staff's analysis of the 21 closed trade practice investigations focused on several potentially mitigating factors, including the complexity of the investigation; the number of firms or individuals involved as potential wrongdoers; the number of potential violations to be investigated; the use of video surveillance; and the volume of documents to be examined by Market Regulation staff. Although video surveillance has played an important role in NYMEX's ability to bring meaningful charges against floor members and their clerks, the analysis of video has added to the time needed to complete an investigation. Based on these criteria, the Division believes the TPIs it reviewed were not open for excessively long periods. Eleven of the cases during the target period involved video surveillance. Three of the 11 video cases involved monitoring the activity of a clerk, and in each case the clerk's privileges were revoked shortly after the investigation was opened. Another video case resulted in an investigative report being presented to the PCC. In one instance, Market Regulation staff explained an apparent time gap due to the fact that the member under review had left the floor for an extended period of time. In addition, the files associated with the four non-video cases generally exhibited extensive analysis.

With respect to the 11 investigations opened prior to the target period that remained open at the conclusion of the target period, Division staff found that mitigating factors justified the prolonged open periods, including, among other things, complex investigations that involved multiple floor traders or obtaining account records for clients based outside the United States. Market Regulation staff acknowledged that one investigation, complicated by a member's failure to provide records, was delayed an inordinate length of time. This member is expected to face charges of failure to cooperate with Market Regulation's investigation. Finally, one investigation that had been open 433 days at the end of the target period had been sent to the

PCC at the time Division staff interviewed Market Regulation staff in conjunction with this review.

#### **E. Conclusions and Recommendations**

The Exchange maintains a trade practice surveillance program that is administered by an experienced staff. Market Regulation's program of investigations and inquiries provides for appropriate investigation of potential trading violations brought to the attention of Market Regulation staff, including member and Commission referrals and customer complaints. Throughout the target period, investigations were thorough and well-documented, and investigation reports included sufficient analysis to support Market Regulation staff's conclusions and recommendations. In addition, investigations were expanded to include additional trading dates or members where appropriate. Investigation files included pertinent underlying trading documents, correspondence, computer reports, tape recordings of witness interviews, references to video surveillance, and summaries of the trading activity examined.

During the target period, the Exchange closed 59 trade practice investigations, of which 24 involved floor trading, 27 involved electronic trading, and eight involved both floor and electronic trading. Investigations were generated from a variety of sources, with the largest number coming from Market Regulation generated reports. Fourteen of the closed investigations were referred to the PCC for disciplinary action. Twenty-eight investigations were closed by Market Regulation staff with no action. Another 17 investigations were closed via staff warning letters. The majority of investigations closed during the target period were closed in less than a year. Of those investigations that were open for more than one year, the length of time the investigations were open was reasonable given their complexity.

Based on the foregoing, the Division has no recommendations.

## VII. DISCIPLINARY PROGRAM

### Core Principle 2 – Compliance With Rules:

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

Core Principle 2 requires that exchanges take effective disciplinary action whenever a rule violation is suspected. Disciplinary actions must be prompt and conducted pursuant to clear and fair standards. Exchanges must have the authority to discipline, suspend, or terminate the activities of members or market participants found to have committed rule violations.

#### A. Disciplinary Committees And Procedures

NYMEX now shares consistent disciplinary procedures and a common disciplinary committee structure with CME and CBOT, which was put in place following the merger. In December 2008, the disciplinary rules at NYMEX were harmonized with the existing rules at CME and CBOT, and essentially adopted the disciplinary committee structure in place at CME prior to the merger. Disciplinary cases in which charges were issued prior to the December 2008 implementation of common disciplinary procedures were completed under the procedural rules and before the disciplinary committees existing at the Exchange prior to the merger.

Under disciplinary procedures now in place, the principal disciplinary committees at the Exchange are a Probable Cause Committee (“PCC”) and a Business Conduct Committee (“BCC”).<sup>45</sup> The function of the PCC is similar to that of a grand jury: it receives and reviews

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<sup>45</sup> The disciplinary process for the Exchange is governed by and described in Chapter 4 of the Exchange’s rulebook. In addition to the two principal disciplinary committees, the Exchange also maintains a Floor Conduct Committee (“FCC”), which has jurisdiction over certain open outcry-related infractions pursuant to NYMEX Rule 514, including failure to indicate a quantity on a bid or offer; use of profane, obscene or unbusinesslike language on the trading floor; and disseminating false, misleading or inaccurate quotes among other violations. The Exchange’s Chief Regulatory Officer is responsible for selecting panels of the FCC to conduct summary proceedings concerning the foregoing infractions as soon as practicable after charges are issued. The panel can impose fines, under an escalating summary fine schedule for repeat offenses, up to \$10,000 per offense, with a ceiling of \$20,000 for all offenses combined. If the panel determines that the infraction was of major importance or warrants a fine beyond

investigation reports from Market Regulation, and determines whether there is a reasonable basis for finding that a violation of Exchange rules may have occurred which warrants the issuance of charges. The BCC holds hearings on contested charges and has overall responsibility for enforcing Exchange rules relating to trading, sales practices, market manipulation or other actions that threaten the integrity of the market, delivery and settlement of the Exchange's contracts, as well as rules relating to trader conduct and the ethical responsibilities of Exchange members and clearing members.<sup>46</sup>

NYMEX and COMEX maintain separate PCC and BCC panels and, during the target period, each panel of the respective committees consisted of seven individuals: a Hearing Panel Chair; three Exchange members or employees of member firms; and three non-members.<sup>47</sup> Panel members are chosen on a rotating basis. The Panel Chair of each PCC or BCC panel, chosen on a rotating basis from a separate pool of potential chairmen, may be either a member of the

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the FCC's authority, it may refer the matter to the PCC for consideration of disciplinary charges. A respondent receiving a fine greater than \$1,000 may file a written appeal with Market Regulation within 10 days of the FCC's decision. Appeals are heard by the BCC, which can only set aside or modify the FCC's decision if it finds that the decision was arbitrary, capricious, or an abuse of discretion, in excess of the FCC's authority, or based on a clearly erroneous interpretation of an Exchange rule. The BCC's decision on appeal is final.

<sup>46</sup> To help ensure application of consistent standards and sanctions across PCC and BCC panels, Market Regulation provides all members of the PCC and BCC panel with a copy of the Exchange's Probable Cause Committee and Business Conduct Committee Handbook, which contains an overview of the Exchange's disciplinary process and sets out Exchange's disciplinary committee policies and the guidelines. Market Regulation also reports Exchange precedents (including actions by other CME Group exchanges) for the type of case involved to each panel as part of its sanction recommendation in each proceeding. Additionally, the PCC and BCC panel composition must include at least one member from the sister exchange, such that each NYMEX case will have a COMEX member as a PCC or BCC panelist, and vice versa for COMEX cases. All panelists (members and non-members) serve on both PCC and BCC panels (though never for the same underlying matter), thus giving each panelist exposure to and experience in all aspects of the disciplinary process.

<sup>47</sup> In November 2010, all of the CME Group exchanges revised the composition of their PCC and BCC panels such that each panel now consists of a Hearing Panel Chair, two exchange members or employees of member firms and two non-members. This change was made as part of a broader effort to reduce the overall size of the committees in order to facilitate greater consistency and continuity from one panel to the next. The overall size of the PCC and BCC committees across all CME Group exchanges was reduced from 166 to 110 panelists.

Exchange or a public individual not associated with the CME Group, its exchanges, or any member of any CME Group exchange.<sup>48</sup>

Throughout the disciplinary process, Market Regulation's Enforcement Group, which is responsible for prosecuting all disciplinary cases, will attempt to settle a case. Respondents may agree to settle a case without admitting or denying charged rule violations, but must consent to entry of findings by the BCC regarding the conduct and rule violations at issue and the penalty to be imposed. Proposed settlements are presented to the BCC for approval. Settlement offers not opposed by Market Regulation may be submitted at any time. For such offers, the BCC considers the respondent's written offer, Market Regulation's written supporting statement, and any relevant statements made during the settlement hearing. Settlement offers opposed by Market Regulation may be submitted only after charges are issued by the PCC. In such cases, the BCC considers the respondent's written offer, Market Regulation's written statement opposing the offer, and any arguments made during the settlement hearing. If the BCC approves a settlement, it must prepare a written decision specifying the Exchange rules alleged to have been violated, stating the panel's findings, and noting the penalty imposed.

Each PCC panel reviewing a Market Regulation investigation report must determine within 30 days of its receipt whether a reasonable basis exists for issuing a Notice of Charges. The PCC and BCC handbook provides that a decision not to issue charges in a case where Market Regulation has alleged customer harm must be "documented in the meeting minutes."

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<sup>48</sup> PCC and BCC members must agree in writing, prior to serving on any panel, that they will not make known to anyone, in any manner, any facts or information that come to their attention in their official capacities as members of the PCC or BCC, except when reporting to Market Regulation, the Legal Department of the Exchange, the Board of Directors or one of its committees, when requested to do so by the Commission or another government agency, or when compelled to testify in a judicial or administrative proceeding.

If the PCC directs that charges be issued, the Notice of Charges must indicate the rule or rules that the respondent is alleged to have violated; describe the conduct involved; advise the member of his or her rights, including the opportunity to submit a written answer to the charges within 21 days of receipt of the Notice; and advise the member of the time and place for the hearing. When a Notice of Charges is issued, the case is referred to a BCC panel for a hearing.

Hearings must be conducted in accordance with Exchange rules that require a fair hearing. The respondent has the right to appear personally and to testify; to be represented by counsel or another person of the respondent's choosing;<sup>49</sup> to examine and obtain copies of all evidence to be relied upon by Market Regulation, prior to the hearing; to submit evidence and call witnesses; and to cross-examine witnesses.<sup>50</sup> At the hearing, Market Regulation presents the evidence supporting the charges, and bears the burden of establishing the basis for a finding of guilt on any charge by a preponderance of the evidence. A majority vote of the panel is required for a finding of guilt.

Exchange rules give the BCC the authority, among other things, to order a member to cease and desist from violative conduct; impose a fine of up to \$1 million per rule violation, plus the monetary value of any benefit resulting from the violation; order restitution to any customer or other person or entity damaged by the member's conduct; impose a period of probation; suspend a member from access to any or all trading or clearing platforms owned or controlled by CME Group; or expel the member. In the case of non-member respondents found guilty of violating the Act or Exchange rules, or of trading in a manner threatening the integrity or

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<sup>49</sup> The person cannot be a member of any Exchange disciplinary committee, a member of the Board, an employee of CME Group or its wholly-owned subsidiaries, or a person related to the underlying investigation.

<sup>50</sup> The respondent must provide copies of all documentary evidence and a list of all witnesses to Market Regulation at least 10 days prior to the hearing. In November 2010, this period was revised to 14 days.

liquidity of any contract, the BCC has authority to order clearing members to liquidate all or part of the non-member's position; order that no clearing member accept new positions on behalf of the non-member; and deny, limit, or permanently bar the non-member's access to Globex or any other trading or clearing platform owned or controlled by CME Group.

Exchange rules provide that promptly following the hearing, the BCC panel must issue a written report of its findings and conclusions. The written report should include at least a short statement "explaining why the BCC Panel . . . found the respondent guilty or not guilty of a rule violation."<sup>51</sup> The PCC and BCC Handbook also provides that where Market Regulation alleged customer harm or sought restitution, if the panel does not find customer harm or order restitution, its written decision must provide a detailed explanation of why customer harm was not found or restitution was not ordered.

A respondent who is found guilty of an offense or is otherwise aggrieved by a decision of or sanction imposed by the BCC may appeal to a hearing panel of the Board of Directors within 10 days of receiving notice of the decision or sanction, provided that the sanction imposed is greater than \$10,000 or a five-day suspension and that Exchange rules do not specifically prohibit an appeal in the circumstances. In addition, subsequent to the post-merger rule changes, Market Regulation may appeal a BCC decision or sanction, or a PCC decision not to issue requested charges, to a hearing panel of the Board within 10 days of receiving notice of the decision. Board hearing panels consist of a director appointed by the Chairman of the Board to serve as chairman of the panel, and two additional directors, one of whom must be a public director.

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<sup>51</sup> NYMEX Rule 408.E.

## **B. Adequacy Of Sanctions**

During the target period, the BCC closed 27 disciplinary cases involving a total of 55 respondents. These 27 closed cases included eight cases that, at the end of the target period, were closed as to some respondents but remained open as to others. Six additional cases remained open as to all respondents at the conclusion of the target period.

To determine whether the disciplinary process at the Exchange is imposing adequate sanctions on violators of Exchange rules, the Division reviewed all of the 27 closed disciplinary cases. The Division found that most sanctions imposed by the BCC during the target period appear reasonable relative to the violations alleged and the evidence presented.

The 27 closed cases involving the 55 respondents were resolved through 19 contested hearings before the BCC and 36 settlement agreements. The Exchange assessed a total of \$1,962,000 in fines, including fines against 53 individuals totaling \$1,897,000 and fines against two firms totaling \$65,000. In addition, NYMEX ordered 12 individuals to pay a total of \$416,138 in customer restitution; suspended 21 individuals for a total of 532 days; and imposed permanent bars on membership against 11 members.

The 27 closed cases included one involving unauthorized trading by a member as a result of not being properly guaranteed by a clearing member and for failing to maintain a minimum account balance required for a lessee; one involving a position limit violation;<sup>52</sup> one involving material misstatements made by a member to Market Regulation concerning a decorum violation;<sup>53</sup> two involving recordkeeping violations; two involving failure to supervise; and 20

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<sup>52</sup> Docket No. 09-02. The BCC found that a firm maintained a position in February 2008 Heating Oil contracts in excess of the applicable speculative position limit in violation of Exchange rules. This excess constituted the fourth speculative position limit violation in a 12-month period for the firm and resulted in a \$50,000 fine.

<sup>53</sup> Docket No. 09-13. The decorum case involved a member who refused to tuck in his shirt and submit his identification card to Exchange staff. Upon questioning by Market Regulation staff, staff determined that the member made numerous material misstatements concerning the events in the case. The case was referred to the



involving substantive trade practice violations that included noncompetitive trading, prearranged trading, trading ahead, fraud, and conduct detrimental to the interests or welfare of the Exchange.

Notable sanctions from the 20 substantive trade practice cases included one case where a telephone clerk of a floor member traded Natural Gas futures contracts and fraudulently assigned his losing trades to certain customer accounts of his employer, and when that failed, he assigned the losing trades to his employer's account resulting in significant losses to the employer. The BCC imposed a \$100,000 fine against the clerk and a permanent ban from re-applying to the Exchange in any capacity.<sup>54</sup> In a similar case that resulted in significant sanctions, a floor clerk and a back-office clerk of a clearing member orchestrated a fraudulent scheme where the floor clerk traded Heating Oil futures contracts for his own benefit and the back-office clerk assisted in the scheme by clearing the trades and locating an account in which his profitable trades could be floated while the unprofitable trades were allocated to the employer of the floor clerk.<sup>55</sup> The BCC determined that the floor clerk's conduct constituted conduct detrimental to the interest or welfare of the Exchange and imposed a permanent bar from applying to the Exchange in any capacity, a fine of \$18,000, and an order to pay \$18,000 in restitution. The back-office clerk received a permanent ban from applying to the Exchange in any capacity and a \$45,000 fine.

In another case, when a phone clerk allocated certain fills intended for a customer order to an account owned by his father, thereby allowing his father's account to effectively profit from trading ahead of customer orders, the clerk was found to have engaged in fraud.<sup>56</sup> Pursuant

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BCC, which found that the member's misstatements constituted an act detrimental to the interest or welfare to the Exchange resulting in a \$5,000 fine.

<sup>54</sup> Docket No. 07-10.

<sup>55</sup> Docket No. 07-32.

<sup>56</sup> Docket No. 09-08.

to a settlement offer supported by Market Regulation, the BCC ordered the clerk to pay a \$30,000 fine, restitution of \$87,806, and not to re-apply to the Exchange in any capacity for two years. The BCC also imposed a \$15,000 fine and a three-month suspension against the father (a COMEX member) for allowing his son to allocate trades to his account for orders he did not place. A third respondent in the case, a floor broker who violated Exchange rules by failing to supervise the phone clerk, received a \$7,500 fine and a three-week suspension.

The BCC also issued meaningful sanctions against three floor brokers in a case involving a pattern of prearranged, noncompetitive trading in Silver futures contracts via open outcry that resulted in customer losses of \$30,700.<sup>57</sup> In this case, the BCC imposed a \$177,500 fine against one broker, ordered restitution of \$30,700 to make the customers whole, and issued an order prohibiting the broker from applying to the Exchange in any capacity for seven years; a \$30,000 fine and order prohibiting the broker from applying to the Exchange in any capacity for six months against the second broker; and a \$22,000 fine and two-week suspension against the third broker.

Although the Division found that the BCC issued meaningful sanctions in most cases during the target period, the Division is concerned about the adequacy of sanctions imposed against one respondent in Docket No. 07-22, a prearranged trading case in the Gold futures pit that involved a total of six respondents. One of the six respondents, a floor broker and COMEX member, submitted an unsupported offer of settlement that was accepted by the BCC and resulted in a \$5,000 fine and a five-week suspension from membership for conduct detrimental to the Exchange, noncompetitive trading, prearranged trading, and withholding orders. A review

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<sup>57</sup> Docket No. 07-01. The investigation in this case was initiated after Market Regulation staff detected possible prearranged trading based on a review of the COMEX Trade Surveillance Investigation Reports. Based on the findings from this review, Market Regulation staff obtained authorization to conduct video surveillance on the floor brokers and the video evidence confirmed a pattern of prearranged trading among the floor brokers.

of this respondent's disciplinary history includes a case from 2008 where the BCC imposed an \$85,000 fine, an eight-week suspension from membership privileges, a five-year suspension from executing customer orders, and ordered restitution of \$9,750 as a result of noncompetitive trading, prearranged trading, and withholding orders, among other violations.<sup>58</sup> As discussed in greater detail in Section VII(D) below, the BCC minutes for this matter were silent as to whether the BCC considered the case from 2008 in determining appropriate sanctions. Nevertheless, the Division believes that the BCC should have rejected the unsupported offer of settlement and imposed a larger sanction as a result of the similar nature of rule violations and the more substantial sanctions imposed in the 2008 case.

### **C. Timeliness Of The Disciplinary Process**

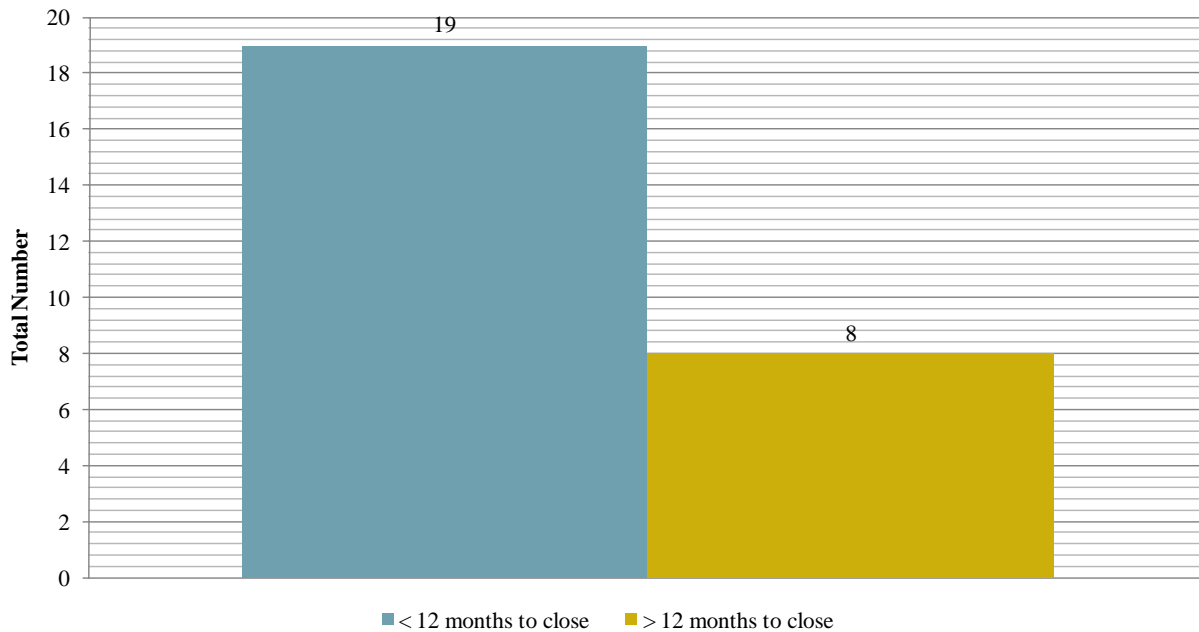
Although the Division found that disciplinary cases closed during the target period were generally completed within a reasonable time, the Division identified three cases closed during the target period (and two cases closed after the target period) that it believes should have been closed in a more timely fashion. As shown below in Figure 10, in 19 of the 27 closed cases, a disciplinary committee decision was issued and the case was closed in less than one year following referral of the investigation involved into the disciplinary process by Market Regulation.<sup>59</sup> The average time that the 27 cases were in the disciplinary process was approximately nine months. Five of the eight cases that were in the disciplinary process for more than one year involved complex factual patterns, multiple respondents, or other reasons, that in the Division's view, justified the longer periods of time for resolution.

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<sup>58</sup> Although the sanctions against this particular respondent in the 2008 case included a five-year suspension from executing customer orders, the activity at issue in Docket No. 07-22, which included withholding orders, occurred prior to the completion of the 2008 disciplinary matter.

<sup>59</sup> The 27 closed cases included eight cases which, as noted above, were closed as to some respondents but remained open at the end of the target period as to other respondents.

Figure 10 – Timeliness of 27 Closed Disciplinary Cases



The Division is concerned about the delayed resolution in three of the eight cases that were in the disciplinary process for more than one year.<sup>60</sup> The Division found that in Docket Nos. 06-14 and 07-01 approximately 11 months elapsed, and 13 months for Docket No. 06-01, between the date of the disciplinary hearing and the date that the BCC issued its written decision.<sup>61</sup> The Division believes that the decisions of the BCC should have been rendered in a more timely manner. Moreover, the delays are inconsistent with the Exchange’s own rule that require a written decision of the panel’s findings to be promptly issued to the respondent

<sup>60</sup> Docket No. 06-01 closed during the target period after remaining open for 23 months, Docket No. 06-14 (29 months), and Docket No. 07-01 (21 months). The Division notes that Docket No. 06-01 remains open with respect to one of the two respondents in the case. The case against the second respondent has been open for approximately four-and-a-half years, including 23 months since the case was initially heard by the Appeals Committee.

<sup>61</sup> The Division also identified two disciplinary cases that closed after the end of the target period where a considerable amount of time elapsed between the date of the hearing and the date of the written decision. Specifically, in Docket No. 07-16, the BCC issued its written decision 16 months after the hearing for one respondent. In Docket No. 07-19, the BCC issued its written decision 20 months after the hearing for one respondent and 23 months later for a second respondent. The Division notes that in Docket No. 07-16 there was a significant delay from the time the complaint was served and the date of the hearing for the one of the respondents (22 months).

following a hearing. While the imposed sanctions appear appropriate in all three cases, such delays weaken the deterrent effect of sanctions and leaves open the possibility of additional wrongdoing by the same respondents.

Market Regulation staff informed the Division of numerous reasons for the delays in resolving some cases during the target period including, among other things: an increase in the disciplinary sanction guidelines in 2008 stymied some settlements and contributed to more respondents electing to go to a hearing; lengthened scheduling timelines as a result of the increase in the number of contested hearings, particularly in cases involving multiple respondents; difficulties related to scheduling the disciplinary panels; respondent attorney conflicts; work on merger-related and integration activities by the Legal Department in New York (which is responsible for drafting the disciplinary committee decisions) challenged the group's resources; and staff turnover in the Legal Department contributed to the delay in the issuance of some written disciplinary decisions. While aware of these potentially mitigating factors, the Division believes that the delay in writing the disciplinary decisions highlights the difficulty in which an under-resourced Legal Department will have in meeting its responsibilities in support of the Exchange's disciplinary program when faced with unexpected or unusual demands on its time and focus. During the target period, only one staff person in the Legal Department was primarily responsible for supporting the Exchange's disciplinary program and drafting the disciplinary decisions for the Exchange. The Division was pleased to learn after the exit conference with the Exchange that the Legal Department now has two staff members that are assigned to support the Exchange's disciplinary program and plans to add one additional staff member whose primary responsibility will be to support the disciplinary programs for all four CME Group exchanges. Nevertheless, the Division believes that the Exchange still must take appropriate action to ensure that disciplinary decisions are issued promptly after a hearing.

#### **D. Adequacy Of Disciplinary Committee Written Decisions**

The Division found that most BCC decisions in matters involving contested hearings or consideration of unsupported settlement offers were adequately explained in the BCC's written decisions. In addition, the Division found that, in general, PCC decisions in matters involving consideration of charges were adequately explained in the PCC's written decisions. However, in one case involving the BCC and in one case involving the PCC, the Division found that the respective committee failed to explain its decision in a way sufficient to enable the Division to review it.

As noted above, Docket No. 07-22 involved six respondents in a prearranged trading case in Gold futures. The Division found that the BCC minutes for five of the six respondents were inadequate. Specifically, the minutes failed to adequately explain Market Regulation's opposition to the unsupported settlement offers that were accepted by the BCC for all five respondents. The Division notes that during the target period, the Exchange modified its practice of only documenting Market Regulation's support or opposition to a respondent's settlement offer in the committee minutes, which the Exchange neglected to do in this case. Today, Market Regulation provides the BCC with a written memo that includes a thorough analysis of a respondent's settlement offer and the respondent's disciplinary history. The Division credits the Exchange with this change, which enables the Division to conduct a more thorough review of the Exchange's disciplinary program.

Nevertheless, the Division is concerned about another aspect of the committee minutes in this case. For two of the six respondents, the BCC cited the respondent's lack of a prior disciplinary history as a reason for accepting the unsupported offers, which the Division agrees should be a mitigating factor for a disciplinary committee to consider when determining appropriate sanctions. However, for two other respondents in this case, the Division is uncertain

whether the BCC considered the respondents' past disciplinary history as relevant in accepting the unsupported settlement offers because the BCC's minutes failed to address this issue. The Division reviewed the disciplinary history for the two respondents and found that both had recently been sanctioned by the Exchange for substantive trade practice violations. While a respondent without a disciplinary history can appropriately be viewed as a mitigating factor, it follows that a respondent with a disciplinary history should be viewed by a disciplinary committee as an aggravating factor in determining appropriate sanctions.<sup>62</sup>

As discussed above, one of the respondents in Docket No. 07-22 received a \$5,000 fine and a five-week suspension for conduct detrimental to the Exchange, noncompetitive trading, prearranged trading, and withholding orders. Although the respondent's disciplinary history includes a case from 2008 with similar Exchange rule violations that resulted in much larger sanctions, the BCC minutes did not address the 2008 case and whether it played a role in its decision to accept the unsupported settlement offer, or whether any mitigating factors contributed to the committee's decision.

Next, a second respondent in Docket No. 07-22 received a \$30,000 fine and a four-week suspension for improper cross trading, prearranged trading, noncompetitive trading, and intentional violation of Exchange rules that results in harm to a customer among other violations. A review of this respondent's disciplinary history revealed that less than one year prior to the sanctions imposed against the respondent in this case, the same respondent received a \$40,000 fine, an eight-week suspension, and was ordered to pay \$17,185 in restitution to affected customers as a result of violating the Exchange's dual trading rules among other violations.

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<sup>62</sup> The Division notes that as a result of the post-merger rule changes, Market Regulation has the authority to appeal, to a hearing panel of the Board, the BCC's sanctions or a decision in which the BCC failed to consider a respondent's disciplinary history.

Although the two cases are distinguishable in that they involved different substantive trade practice violations, both involved customer harm, which in the Division's view, must be a critical factor in determining appropriate sanctions. However, because the committee minutes did not mention the respondent's disciplinary history, the Division is unable determine whether the BCC even considered this prior case as a factor in its decision to accept the respondent's unsupported settlement offer.

In Investigation No. 06-898-011007, Market Regulation recommended that the PCC issue charges against two traders for executing a noncompetitive, prearranged trade opposite a floor broker who traded ahead of his customer's Heating Oil futures order. After the hearing, the PCC declined to issue charges against the two traders and instead issued warning letters. The only explanation the PCC provided for its decision was a brief statement in the minutes that the PCC "found that rule violations may have occurred, but citing mitigating circumstances rejected Market Regulation Department staff's recommendation to issue a Complaint." The PCC did not elaborate to any extent as to the nature of the mitigating circumstances.

Written explanations of the reason for PCC decisions not to issue charges are essential to an adequate disciplinary program. PCC decisions which do not follow relevant exchange rules or provisions of the Act and Commission regulations, or do not apply correct standards of proof, could deprive an exchange of effective ability to enforce compliance with its rules, sanction trading violations, and deter misconduct. Moreover, a lack of appropriate explanation of decisions not to issue charges could impede effective Market Regulation appeal of such decisions.

It is worth noting in this connection that exchange disciplinary committees are not independent, unreviewable, unsupervised judicial bodies against whose decision-making



procedures an exchange has no recourse. Rather, disciplinary committees are creatures of the exchange's Board of Directors and subject to the Board's authority, and the Board remains ultimately responsible for disciplinary committee exercise of the Board's delegated responsibility to ensure that the exchange's disciplinary program includes adequate disciplinary and sanctioning processes. Review of the work of disciplinary committees, and steps to remedy any disciplinary committee failure to follow relevant provisions of the Act, Commission regulations, and exchange rules, is ultimately a responsibility of the Board, and in particular of the Board's Regulatory Oversight Committee ("ROC"), comprised of public directors. The CME Group Board and MROC cannot effectively review the Exchange's disciplinary program if written disciplinary decisions do not explain the basis for the committee's conclusions. Inadequate written decisions also prevent the Division from conducting a thorough review of the Exchange's disciplinary program.

Accordingly, the Division believes the Exchange should ensure that all decisions by the BCC to accept unsupported offers of settlement, and all decisions by the PCC not to issue charges, are adequately explained in writing.

#### **E. Conclusions And Recommendations**

The Division found that NYMEX maintains an adequate disciplinary program. During the target period, the Exchange took final disciplinary action in 27 cases involving 55 respondents. The Division reviewed all 27 cases and found that most sanctions imposed by the BCC appear reasonable and appropriate in relation to the violations alleged and the evidence presented, and reasonably calculated to deter similar violations. However, the Division identified one case involving a repeat offender, for which it believes that the BCC should have imposed a larger sanction. The BCC must ensure that all sanctions are sufficient to serve as an effective deterrent to recidivist activity.

Although the Division found that 24 of 27 disciplinary cases were completed within a reasonable time, the Division identified three cases in which the BCC failed to issue a written decision of the panel's findings promptly after the hearing. Lengthy delays in completing disciplinary cases have a deleterious effect on the overall effectiveness of an exchange's rule enforcement program because, among other things, prompt resolution to disciplinary cases is necessary to discourage further violations of exchange rules.

With respect to the consideration of whether to issue charges and the consideration of settlement offers, the Division found that most conclusions reached by the PCC and BCC were adequately explained in the respective committee's minutes. The Division found, however, one case in which the PCC and once case in which the BCC failed to explain their decisions in a manner sufficient to enable thorough Division review of the Exchange's disciplinary program. Written explanation of the reason for PCC decisions not to issue charges should be required, in order to ensure the Exchange's ability to enforce compliance with Exchange rules, sanction trading violations, and deter misconduct, and to avoid impeding effective appeal of such decisions by Market Regulation where needed. At the same time, in one case before the BCC, the committee minutes did not address whether the committee considered the disciplinary history for two respondents that had been recently been sanctioned by the Exchange for substantive trade practice violations. The Division believes that while a respondent without a disciplinary history can appropriately be viewed as a mitigating factor in determining appropriate sanctions, it follows that a respondent with a disciplinary history should be viewed by a disciplinary committee as an aggravating factor in determining appropriate sanctions.

Based on the foregoing, the Division recommends that:

- The Exchange should ensure that the BCC imposes meaningful sanctions on members who violate the same or similar Exchange rules to discourage recidivist activity.

- The Exchange should take appropriate action to ensure that disciplinary decisions are issued promptly after a hearing.
- The Exchange should ensure that all written decisions by the BCC, including acceptance of unsupported settlement offers, and all decisions by the PCC not to issue charges, are adequately explained in writing in committee minutes. The written decisions should include findings and conclusions with respect to each charge, and the findings with respect to each charge should state and explain the reason or reasons for the committee's conclusion with respect to that charge, note the evidence which led the committee to that conclusion, and explain the basis for the sanction imposed. The committee's decision should also explain the role, if any, that a respondent's disciplinary history factored into decisions to accept unsupported settlement offers and decisions regarding sanctions.