For Public Release

Market Surveillance Rule Enforcement Review of the Chicago Board of Trade

COMMODITY FUTURES TRADING COMMISSION ☆ 1975 ☆

Division of Trading and Markets

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MARKET SURVEILLANCE
RULE ENFORCEMENT REVIEW OF THE
CHICAGO BOARD OF TRADE

I. INTRODUCTION

The Division of Trading and Markets ("Division") has completed a rule enforcement review of the market surveillance program at the Chicago Board of Trade ("CBOT" or "Exchange").[1] The purpose of the review was to evaluate the Exchange's compliance with Section 5a(a)(8) of the Commodity Exchange Act ("Act") and Commission Regulation 1.51(a)(1) during the period of November 1, 1999 to November 1, 2000 ("target period").[2]

The previous rule enforcement review of the CBOT's compliance program was presented to the Commission in a report dated June 30, 2000 ("2000 Review"). That review evaluated the Exchange's trade practice surveillance and disciplinary programs, and did not include a review of the Exchange's market surveillance program. CBOT's market surveillance program was last reviewed in a report to the Commission dated February 12, 1997 ("1997 Review"). In the 1997 Review, the Division found that the Exchange maintained an adequate market surveillance

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

[2] Since the target period for this rule enforcement review concluded prior to enactment of the Commodity Futures Modernization Act of 2000 ("CFMA"), the Division conducted this review based on the requirements of the Act and Commission regulations existing during the target period, rather than on the basis of the core principles set forth in the CFMA.

program. The Exchange effectively monitored contract expirations for potential manipulation and other disruptive market situations and, among other things, routinely tracked statistical information, such as price changes, spread differentials, deliverable supplies, reportable positions, volume and open interest.

In conducting its current review, Division staff interviewed Exchange officials, including the Senior Vice President and Administrator of the Office of Investigations and Audits ("OIA") and two OIA Managing Directors.[3] Division staff also reviewed Exchange documents that included computer reports and other documentation used routinely in the conduct of market surveillance; market surveillance and compliance manuals and guidelines; market surveillance investigation and disciplinary action files for cases closed during the target period; market surveillance logs; minutes of disciplinary committee and Board of Director meetings held during the target period; and sample Expiration Summary Files.[4]

The Division provided the Exchange with the opportunity to review and comment on a draft of this report on June 21, 2001. On June 28, 2001, Division staff conducted an exit conference with CBOT market surveillance staff to discuss the report's findings and recommendations.

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[3] A copy of the transcript of the January 10, 2001 interviews can be found in Appendix 1.

[4] The Division included a sample of MidAmerica Commodity Exchange ("MidAm") documents and files in its review. The CBOT, pursuant to a March 4, 1986 affiliation agreement, is responsible for the MidAm's rule enforcement program.

II. SURVEILLANCE OF MARKET ACTIVITY

A. Market Surveillance Department

OIA monitors member compliance with CBOT rules and regulations. OIA is comprised of five departments, including the Market Surveillance Department ("MSD") and Regulatory Reporting and Research ("RRR") Department. These two departments are responsible for administering the market surveillance program at the CBOT. The MSD consists of a Managing Director, a Senior Manager, a Manager, a Supervisor, an Assistant Supervisor, an Assistant Market Analyst, and an Administrative Assistant.[5] All but the Managing Director and the Administrative Assistant function as market analysts, responsible for monitoring their assigned markets.

The Managing Director is responsible for overseeing the operation of the MSD and the Registrar's Office, which certifies and monitors supplies deliverable against CBOT contracts. He also serves as the staff liaison to the BCC. The BCC is the member committee responsible for, among other things, ensuring that contracts expire in an orderly fashion. The MSD staff has extensive industry and Exchange experience, ranging from four to ten years for the staff and 15 years for the Managing Director.

The RRR Department is responsible for collecting and monitoring reportable trader information that it receives from clearing firms. RRR works closely with firms to ensure that all reportable positions are reported promptly to the Exchange, and that the information is accurate

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[5] Since the close of the target period, the Manager and Supervisor have left the MSD. Their positions were filled via internal transfers from other OIA departments to MSD.

and complete. RRR has a Managing Director and three staff positions with market surveillance responsibilities, including a Supervisor and two Accounting Assistants. [6]

B. Prices, Volume, Open Interest, and Market News

The MSD collects and analyzes price, volume, open interest, and market news on a daily basis for each contract. The information is used in connection with its routine surveillance of market activity and contract expirations. Each analyst is responsible for monitoring trading activity, price movement, volume, open interest and market developments in each of their assigned markets. Exchange generated reports provide analysts with trader positions, futures and option prices, and volume and open interest statistics. These data are obtainable on-line or in historical files in the MSD.

Cash price data are collected from a variety of sources, including Bloomberg, the Internet and newsletter subscriptions. The primary and most reliable source of cash price information consists of phone interviews with cash market participants. This enables MSD to verify the reliability of published price reports in order to quickly and efficiently identify unusual or abnormal price relationships.

C. Contract Expirations

1. Heightened Surveillance

The MSD intensifies surveillance of expiring contracts in an effort to facilitate orderly liquidations. This heightened surveillance typically begins around First Position Day. [7]

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[6] After the target period, the function of monitoring and collecting large trader information was moved to the MSD. RRR staff performing that function were transferred to the MSD.

[7] First Position Day occurs two business days before the first day allowed for deliveries in that month.

Surveillance focuses on closely monitoring cash and futures prices, spread and basis relationships, size and ownership of deliverable supply, size of large trader positions relative to the total open interest and deliverable supply, and the positions of other large traders. Analysts may also conduct extensive phone interviews with cash and futures market participants.

If a potential expiration problem arises, MSD staff so informs the BCC. The MSD presents summary reports with relevant information to the BCC and keeps the committee apprised of market conditions. The MSD also discusses large trader positions, any concentrations of positions, and the overall market situation with the BCC. The BCC meets as needed during expiration and has the authority to take several types of action to avoid potential market disruptions, such as recommending to the Board of Directors that it limit trading to liquidation only. In addition, the MSD, acting on behalf of the BCC, can issue letters reminding market participants of their responsibilities to contribute to an orderly liquidation.

The Division found that when unusual market circumstances, trader concentrations or other factors raise the potential for a liquidation problem, MSD routinely makes inquiries to learn the intentions of the largest traders, particularly with respect to making or taking delivery. This information enables MSD and the BCC to evaluate more fully the nature of the market and the likelihood of a problem. This approach was demonstrated during the one potentially problematic liquidation during the target period. That situation involved a concentrated long position in the September 2000 rice contract, which eventually expired in an orderly manner after successful MSD jawboning.

2. Expiration Summary Files

The MSD routinely compiles Expiration Summary Files ("ESFs") containing daily data on each expiring contract. Staff begins to assemble the ESFs approximately six weeks prior to expiration. They are comprised of all analyses, reviews, and actions taken during expirations. The files contain spreadsheets that provide a snapshot of daily comparisons of futures prices, spread prices, cash values, futures versus cash prices, deliverable supplies, barge freight rates, warehouse registrations, receipts and shipments, and delivery notices. The ESFs also contain comprehensive documentation of conversations with market participants, [8] large trader positions, relevant news stories, and other pertinent statistical data, such as volume, open interest, and clearing member positions.

A major focus of the ESF is the data concerning concentrations of positions. The concentration data are contained in two reports, the Adjusted Net Position Report and the Large Trader Aggregate Report. The Adjusted Net Position Report details the positions of all clearing members in the spot month separately by aggregate house and customer positions. The Large Trader Aggregate Report contains large trader positions submitted by each clearing member. The ESFs also contain economic or agricultural news stories and an analysis of the extent to which the news may have influenced prices. Finally, narrative summaries of the expirations and any potential problems that may have existed are also provided.

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[8] Each interview record consistently included the following data: (1) date and time of the interview; (2) analyst; (3) commodity and future; (4) interviewee and firm represented; (5) subject; and (6) brief notes or a narrative summary describing the topics addressed and information exchanged. Interviews included discussions of cash values, movement of stocks, sales commitments, and spread values. Correspondence and conversations with Commission surveillance staff were also documented.

The Division examined ten representative ESFs prepared during the target period to evaluate the substantive nature of the information and the adequacy of documentation. Each ESF provided comprehensive documentation of the Exchange's surveillance activities and actions taken with regard to expiring contracts. The ESFs contained documentation of surveillance activities conducted during the expiring month, including contacts with major market participants and cash market trade sources. Appropriate analyses were conducted on cash prices, price bases, spread relationships, large trader positions and their relative market share, and possible concentrations. In addition, price analyses, large trader, and clearing firm position data included in the ESFs for both agricultural and financial contracts generally covered information throughout the expiration month. Finally, interviews were well documented and provided MSD staff with important insights into hedging strategies, underlying cash market activity, liquidation intentions, and other information that may be of importance to ensure an orderly expiration.

D. Large Trader Reporting System

The Exchange monitors positions in all markets through its Large Trader Reporting System ("LTRS"), which contains a substantial database of position information. Exchange rules require clearing members to report daily any position that at the close of trading is greater than or equal to the reportable position levels established by the Exchange for each contract.[9] Data from the LTRS are used to enforce compliance with CBOT regulations regarding reportable accounts, speculative position limits, omnibus account reporting, open interest reporting, aggregation of accounts and any other aspect of large trader reporting. Extensive reportable

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[9] A list of all CBOT reportable levels can be found in Appendix 2.

trader information is used by MSD analysts in the performance of their routine surveillance efforts.

Analysts may access data through a series of computer reports and on-line screen applications that analyze large trader activity according to predetermined sorts.[10] For example, analysts can monitor position data via the Large Trader Omnis 7 Report. This report lists, by firm, each reportable account and position. The report can be sorted in a number of ways, including by date, firm, account number, account name, and commodity.[11] Another report, the Large Trader Report, identifies new reportable traders. This report allows the MSD to become familiar with the identities of reportable traders and monitor effectively accounts that should or could be aggregated for speculative limit purposes.[12]

Other daily reports monitor open interest reporting. For example, the Audit Exception Report sets forth each individual firm's reported open interest and large trader positions on a daily basis. This report indicates when open interest and large trader positions do not reconcile, such as when a firm double reports or fails to report large trader positions.[13] Exchange staff will contact firms to collect any missing data and resolve any discrepancies between a firm's open interest and its reportable trader positions.

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[10] The large trader reporting system maintains six months of large trader data on-line, after which time data are archived for five years.

[11] A copy of the Large Trader Omnis 7 Report can be found in Appendix 3

[12] A CFTC Form 102, which contains, among other things, account ownership and control information, is requested for each new large trader. The Form 102 information is entered into the LTRS for aggregation purposes. A copy of the Large Trader Report can be found in Appendix 4.

[13] A copy of the Audit Exception Report can be found in Appendix 5.

In this regard, one clearing firm inadvertently neglected to report a portion of its open interest in January 2000 Fed Funds futures to the Board of Trade Clearing Corporation ("BOTCC") from July 19 to November 1, 2000.[14] The firm also did not report large trader positions in that contract to either the CBOT or the Commission. However, because the Audit Exception Report is not useful in detecting instances where firms neglect to report both open interest and large trader positions, the anomaly went undetected until September 8, 2000. At that time, the Commission's surveillance staff found a substantial discrepancy between long and short open interest in the January 2000 contract, such that aggregate reportable large trader long positions greatly exceeded short open interest. Commission staff referred the discrepancy to the MSD and the BOTCC via telephone on September 8th and, upon investigation, the CBOT, on November 6, 2000, fined the clearing firm $15,000 for reporting violations.

Although the Exchange did not identify the discrepancy, the incident appears to have been a unique occurrence, and the CBOT and BOTCC have taken steps to help identify such anomalies in the future. Specifically, since the violations, the BOTCC has developed, and shares with the MSD, an exception report that compares changes in open interest to daily volume by clearing firm. In addition, the MSD now routinely investigates differences in long and short open interest. Both of these steps should be useful in identifying similar instances of reporting violations.

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[14] The firm's computer system categorizes accounts into various levels and subclasses, some of which involve automatic position reporting to the Exchange and to the Commission. The error occurred when operational considerations moved an account from a subclass that was being reported to one that was not being reported. Correction of the error involved changing the non-reporting subclass to a reporting one.

E. Enforcement of Speculative Position Limits and Exemptions

1. Speculative Limits

The MSD also is responsible for enforcing the CBOT's speculative position limit rules.[15] On a daily basis, analysts review the Large Trader Exception Report, which shows accounts that are over position limits in a given commodity by contract month and all future months combined.[16] The report includes gross futures and options positions, as well as net futures-equivalent positions.[17] Once a position appears on the Large Trader Exception Report, the analyst verifies with each reporting futures commission merchant ("FCM") that the position is accurate. The MSD then instructs the FCM(s) and/or the account either to reduce the position or to apply for an exemption to the position limits, if eligible. If the account does not appear to be eligible for a position limit exemption or does not intend to apply for such an exemption, MSD opens a position limit investigation, which is entered into a case log.

Pursuant to Exchange procedures, the first time an account (or aggregated accounts) exceeds a position limit, a reminder letter is sent to that account, regardless of whether it's the account of a member or a non-member. A reminder letter is also sent to the FCM(s) carrying the position. If that account exceeds the position limit again in the same commodity within 12 months, the matter will be referred to the BCC with a recommendation from the MSD for disciplinary action. Of course, only members can be charged and sanctioned. Thus, if a non-

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[15] CBOT rules 425.01 and 495.01 govern position limits and reportable positions in futures and options, respectively.

[16] A copy of the Large Trader Exception Report can be found in Appendix 6.

[17] Generally, position limits are expressed in futures-equivalent contracts. The only CBOT contracts that had separate option position limits are the Catastrophe Insurance option contracts.

member account is found to be in violation of position limits, the FCM(s) that carried the position is subject to disciplinary action.

During the target period, the MSD closed 29 position limit investigations. All investigations involved CBOT grains, except for one investigation involving 10-year Agency Notes and one involving MidAm corn. Twenty-two of these investigations pertained to spot month position limits. Typically these involved entities that inadvertently exceeded spot month limits on the first day for which those limits were in effect or entities that had issued a notice of intention to deliver at the start of the spot month (but delivery had not yet occurred), leaving a spot month position that was not in excess of limits. Fourteen of the 29 investigations resulted in the issuance of reminder letters. The remaining 15 were closed with no violations found.

Division staff reviewed 15 position limit investigation files for adequacy. The investigations were thorough, well documented, and completed in a timely manner.[18] The Division notes one investigation, however, that it believes should have been referred to the BCC for possible disciplinary action.[19] In that matter, an account exceeded the March 2000 soybean spot position limit by 50 contracts. The account had previously exceeded the single month position limit in December 1999 soybean oil by 93 contracts, the spot month limit in March 1997 corn by 300 contracts, and the spot month limit in December 1996 corn by 434 contracts.[20]

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[18] Typically, each file contained the following: a report summarizing and closing the investigation; a Speculative Limit Review form which documents the steps taken during the investigation; copies of appropriate correspondence with FCMs requesting and producing account statements and other relevant documents; various Large Trader position reports; a spreadsheet illustrating the subject positions during the time in which position limits were exceeded until the position comes into compliance; copies of CFTC warning letters issued in the matter; and copies of any reminder letters issued to the account and FCMs.

[19] Investigation No. 00-RRI-007.

[20] Investigation Nos. 99-RRI-029, 97-RRI-003, and 96-RRI-033.

Because the owner of the account was a non-member and the Exchange had no disciplinary authority, and consistent with Exchange policy, the MSD issued a reminder letter to the account owner. However, the individual controlling the trading in the account was a full member and the account owner's spouse. In light of the account controller's status as a full member and the account's history of exceeding speculative limits in three of the previous four years, the Division believes the matter should have been forwarded to the BCC for consideration of further action.[21]

2. Speculative Limit Exemptions

Pursuant to Exchange rules, speculative limit exemptions may be granted for bona fide hedges and, for non-agricultural commodities, risk management positions, cash/futures arbitrage, intra-market spreads, and inter-market spreads.[22] Exemptions to position limits, otherwise known as "hedge exemptions," are not granted to speculators. There are separate applications for agricultural and financial commodities. Each application requests that the hedger or spreader specify, in contract equivalents, the maximum number of contracts, long or short, sought for exemption for all contract months combined. The application also requires a statement that the intended positions are consistent with the Exchange's definition of bona fide hedging and a justification for the exemption.

Position limit applications are either submitted in anticipation of exceeding a position limit or as a result of exceeding a position limit. Accounts that exceed a position limit in any

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[21] In addition, although it is MSD procedure to send a reminder letter to first-time speculative limit violators and their carrying firms, Division staff noted two instances where reminder letters were not sent to the carrying FCMs. See Investigation Nos. 00-RRI-002 and 00-RRI-008.

[22] CBOT rules 425.02, 425.03, and 425.04 describe requirements and categories of allowable position limit exemptions in futures contracts. Similarly, rules 495.02, 495.03, and 495.04 govern position limit exemptions for option contracts.

commodity are required to submit a hedge exemption application within 10 business days. In addition, accounts that exceed a spot month position limit are required to submit cash position documentation within five business days.

When deciding whether or not to grant an exemption from position limits, MSD staff considers the applicant's cash positions, anticipatory cash positions, liquidity of the futures/options contract for which the exemption is requested, the economics of the cash/futures relationship, and other exemptions of a similar nature which have been granted. Position limit exemptions are expressed in terms of the number of contracts by which an account may exceed applicable position limits and are granted for a period of 18 months. Applicants must submit a supplemental application if there are material changes to the information provided in the most recent filing. After 18 months, each previously approved exemption is updated by MSD if and when the account is in excess of position limits. During this process, MSD requests updated cash/hedging information and re-examines how the account's exemption is used to hedge. The MSD maintains a "Hedge List" database that describes approved hedge exemptions, including expired exemptions, which have been initiated or renewed since 1989.[23]

During the target period, MSD had 200 approved hedge exemptions in place for 85 applicants. Some applicants have exemptions in multiple commodities, and others have exemptions in a single commodity, but through accounts at multiple FCMs. One hundred

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[23] The list includes the name and code number identifying the FCM through which the exemption application was made, the account name and number, the Exchange Index number (by which commonly owned and/or controlled accounts are aggregated), the commodity, the number of contracts approved in excess of the position limit on the long and the short side separately, the reason the exemption was approved, the date of initial approval, the date of the most recent renewal, the expiration date of the exemption, and relevant notes pertaining to the account being exempted. A recent copy of the Hedge List may be found in Appendix 7.

twenty-seven of the 200 exemptions, for 58 different applicants, were either initiated or renewed during the target period. Division staff reviewed six representative exemption files for completeness. These files included exemption applications for corn, wheat, soybeans, soybean meal, Ten-year Agency, and Two-year Treasury Note futures contracts. Two of these applicants filed for multiple exemptions. Each file was well documented and complete, containing the application and appropriate justification, sufficient cash market information (often a CFTC Form 204),[24] an MSD worksheet used to help determine an appropriate exemption level, CBOT position reports, and relevant correspondence and memoranda. Further, both financial market exemption files included appropriate duration ratio analyses.[25]

3. Position Accountability

Position accountability rules exist for 30-year Treasury Bond, 10-year Treasury Note, and Five-year Treasury Note futures and options contracts, as well as for 30-day Fed Funds futures. In place of absolute position limits, the accountability rules mandate levels at which large traders may be required to respond to special requests by the Exchange for information relating to their positions. Specifically, the accountability rules provide that any trader who exceeds the former speculative position limits will be required to provide "in a timely manner upon request by the

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[24] CFTC Form 204 contains information about cash positions in grains and soybean products and is required from any reportable trader positions in excess of federally imposed position limits.

[25] Duration is a measure of the sensitivity of the price of a bond with respect to changes in interest rates. Bonds with different cash flows (different maturities, coupon rates, and coupon dates) have different sensitivities to changes in interest rates. A duration-based hedge ratio is the conventional, although not the only, method to hedge against price changes of a fixed-income instrument. MSD routinely considers the duration of a portfolio of fixed-income instruments to determine the appropriate number of futures contracts needed to hedge that portfolio.

Association, information regarding the nature of the position, trading strategy, and hedging information if applicable."[26]

Generally, the MSD does not find it necessary to formally invoke the accountability rules to collect information about positions. The MSD surveillance analysts regularly contact major participants in CBOT markets to gather information regarding the nature of positions, trading strategies, and hedging information. These communications between MSD and market participants are clearly reflected in the ESFs reviewed by Division staff. It is MSD procedure for each analyst to maintain contact with market participants, both during and outside expiration months, and to build a rapport with those participants. Usually, MSD speaks directly with the person making trading decisions for a particular trading entity. It should also be noted that MSD contacts a market participant without regard to whether or not that participant is a member of the Exchange. The MSD believes that by building lines of communication with major participants, it is able to routinely collect necessary surveillance information in a timely way. However, MSD is prepared to formally invoke its accountability rules if needed.

The trading position, trading strategy, and cash market information routinely collected by MSD staff and evident in the ESF files, represent an adequate program to monitor positions in excess of the former position limits in commodities for which position accountability rules now apply.

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[26] Rules 425.06, 425.07, and 425.08 govern position accountability in Treasury Bond, Treasury Note, and Fed Funds futures contracts, respectively. Rules 495.06 and 495.07 govern position accountability in Treasury Bond and Treasury Note option contracts, respectively.

F. Exchange of Futures for Physicals

CBOT Regulations 444.01 and 444.02 authorize and govern EFPs. EFPs may be executed at such prices as are mutually agreed upon by the two parties to the transaction. The member firms clearing an EFP transaction must subsequently approve the terms of the transaction, including the clearing firm, price, quantity, commodity, contract month, and date prior to submitting the transaction to the BOTCC. An EFP is not considered to be bona fide if the parties execute another cash transaction that is contingent upon the EFP and that economically offsets the cash portion of the EFP transaction.[27]

EFPs must involve only two parties such that the seller of the futures is the buyer of cash, and the seller of cash is the buyer of futures. Separate profit centers of the same legal entity, which are under separate trading control, may engage in EFP transactions with each other. In cases where the parties to an EFP involve the same legal entity, same beneficial ownership, or separate entities under common control, the parties must demonstrate that the EFP was a legitimate arms length transaction.

The Exchange requires third-party documentation that the cash portion of the transaction was indeed exchanged, whenever applicable. For T-Bonds and T-Notes, acceptable third-party documents include a Federal Reserve Wire Transfer, or a bank confirmation, but do not include internal bookkeeping documents of a firm involved in the transaction. For financial EFPs where the two parties execute an independent cash transaction, which would normally be netted out

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[27] However, in accordance with a Notice to Members dated January 6, 2000, the following is permitted for the purpose of obtaining inventory financing for an agricultural commodity: "Through the medium of an EFP, and in accordance with Exchange rules and regulations, a participant may purchase grain from and sell offsetting futures contracts to a counter-party. Simultaneously with the EFP, the participant may grant to the counter-party the non-

against the cash portion of the EFP transaction, the same independent third-party documentation of the transfer of the cash portion of the EFP, i.e., a Government Securities Clearing Corporation netting confirmation, is requested. Copies of warehouse receipts showing the proper endorsements and checks for payment are required if used as the cash portion of a grain EFP, and a copy of the cash contract is required for forwards that are used as the cash portion of an EFP.

The MSD routinely reviews EFPs to ensure that the transactions are bona fide and that all required cash documentation exists. Approximately 30 inquiries are conducted each year. The MSD uses its on-line Cleared EFP Report, which lists data pertaining to all EFP transactions for the previous year and the ability to sort these data in various ways, to select EFPs for review. EFP transactions are chosen for review based upon various criteria including, but not limited to, the size of the transaction (unusually small or large), the same clearing firm is on both sides of the EFP, the futures leg is priced outside the daily range for that contract,[28] the EFP is executed after the last trading day, or the nature of the account or apparent relationship between the accounts for which the EFP was executed raise questions.

During the target period, the MSD closed 27 EFP investigations, 14 pertaining to financial products and 13 pertaining to agricultural commodities. For the purpose of evaluating the adequacy and timeliness of Exchange EFP investigations, Division staff reviewed 16 of the 27 closed investigations. The files were well documented and completed in a timely manner.

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transferable right to effect a second EFP on some date certain in the future which will have the effect of reversing the original EFP.

[28] While pricing the futures leg of an EFP transaction outside of the day's trading range is not a violation of Exchange rules, most EFPs are priced at current market prices. If the legs of an EFP are priced away from current market levels, it may indicate a motivation that is not purely economic. The differential between the futures and cash prices (the basis) of a bona fide EFP must reflect the market price.

Each file included an Investigative Summary Report, which described the salient features of the review; a "T-chart" describing the flow of cash and futures; a detailed activity log listing all pertinent communications and steps in the investigation; pertinent cash documentation; an analysis of the appropriateness of the ratio of cash and futures contracts exchanged; futures order tickets; account statements; and all relevant correspondence. The MSD routinely analyzed the futures price relative to the day's trading range, as well as the price differential (basis price) at which the cash and futures contracts were exchanged to determine if the differential reflected market prices.

Of the 27 EFP investigations closed during the target period, only three were open for an extended period of time. These investigations took from 10 to 21 months to complete. However, the complexity of the three investigations justified the additional time necessary for completion. In addition, each of the three resulted in sanctions, as discussed below.

G. Adequacy of Market Surveillance Investigations

Exclusive of speculative limit and EFP investigations, the MSD closed five additional investigations during the target period. Division staff reviewed all five of these investigations for adequacy and timeliness. Two of these investigations involved clearing firms that misreported open interest;[29] one involved a clearing firm that improperly offset positions during a delivery month;[30] another involved a clearing firm that failed to report long positions, which impacted delivery assignments;[31] and one involved a decorum violation.[32] Of the five

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[29] Investigation Nos. 00-RRI-006 and 00-RRI-023.

[30] Investigation No. 99-RRI-046.

[31] Investigation No. 00-MSI-01.

investigations, four resulted in sanctions and one resulted in the issuance of a reminder letter. All of these investigations were completed expeditiously, and were conducted in a thorough manner.

III. MARKET SURVEILLANCE DISCIPLINARY ACTIONS

A. Sanctions

During the target period, nine MSD cases were presented to the BCC for consideration of disciplinary action. Four of the cases involved EFP transactions, three involved position or open interest reporting, one involved a position limit violation, and one involved supervision and decorum. The cases resulted in 10 monetary sanctions totaling $192,250, two cease and desist orders, and two reminder letters.

The largest sanction of $125,000 was levied against a member firm for executing contingent EFPs; a sanction of $30,000 was levied against a clearing firm for failing to report a long position which was eligible for delivery; and sanctions of $15,000 and $5,000, respectively, were levied against clearing firms for executing contingent EFPs. Three other $5,000 fines were levied against clearing firms, one for misreporting open interest; one for misreporting option positions; and one for supervision and decorum offenses. Sanctions of $1,000 each were levied against two member firms for executing an EFP transaction in which there was no exchange of the cash commodity; and a $250 fine was levied against a registered floor clerk for a decorum offense. No disciplinary hearings were held during the target period; all of the penalties imposed

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[32] Investigation No. 00-MSI-02.

resulted from settlement agreements. The penalties appear reasonable relative to the conduct being sanctioned.

B. Timeliness of Disciplinary Procedures

The Division found that the BCC reviewed investigation reports and disposed of matters promptly. Seven of the nine cases brought before the BCC were disposed of within two months. One complex EFP case, in which sanctions totaled $140,000 between two parties, was disposed of within six months. Only one case remained open with one of the two respondents involved for 13 months due to settlement negotiations.

IV. CONCLUSIONS AND RECOMMENDATIONS

The Division found that the Exchange maintains an effective and comprehensive market surveillance program. The MSD routinely monitors, among other things, price relationships, volume, open interest, deliverable supply and market news, and maintains a large trader reporting system that contains a substantial database of position information. The MSD also maintains complete and comprehensive contract expiration files. In order to facilitate an orderly liquidation, surveillance is heightened in each contract as expiration approaches, as well as when any potential problem arises. In addition, the MSD routinely communicates with market participants, both members and non-members, and these communications are well documented.

The Exchange also has effective programs for monitoring speculative position limits and the bona fides of EFPs. However, one speculative limit investigation involving a non-member account that had violated speculative limit rules on several previous occasions and that was controlled by a member, should have been referred to the BCC for consideration of charges.

Finally, nine market surveillance related cases were presented to the BCC for disciplinary action. The BCC reviewed investigation reports and disposed of these matters promptly. In total, $192,250 in fines were assessed, with one EFP case resulting in fines of $140,000. All market surveillance-related sanctions during the target period were the result of settlement agreements. The penalties imposed appear reasonable relative to the conduct being sanctioned

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

Ensure that members who control the trading of non-member accounts are accountable for speculative position limit violations.