

RULE ENFORCEMENT REVIEW

CBOE Futures Exchange, LLC



Division of Market Oversight

September 6, 2013

**RULE ENFORCEMENT REVIEW OF
CBOE FUTURES EXCHANGE, LLC – AUDIT TRAIL PROGRAM**

Commodity Futures Trading Commission – Division of Market Oversight

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I. Introduction

The Division of Market Oversight (“Division”) has completed a rule enforcement review of the audit trail program of CBOE Futures Exchange, LLC (“CFE” or the “Exchange”).¹ The review focused on compliance with two core principles under Section 5(d) of the Commodity Exchange Act (“Act” or “CEA”) and Part 38 of the Commission’s regulations.² The Division’s 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. This examination is a follow-up to the Division’s initial review of the Exchange’s audit trail program which covered the period from November 1, 2009 through November 1, 2010 (“first target period”).

¹ Rule enforcement reviews prepared by the Division are intended to present an analysis of an exchange’s overall compliance capabilities during the period under review. Such reviews deal only with programs directly addressed in the review and do not assess all programs or core principles. The Division’s analyses, conclusions, and recommendations are based, in large part, upon the Division’s evaluation of a sample of investigations 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.

The findings and recommendations in this rule enforcement review are limited to CFE and its respective products. This rule enforcement review, and the findings and recommendations herein, represent the view of the Division only, and do not necessarily represent the position or view of the Commission or of any other office or division of the Commission.

² The Division’s rule enforcement review of CFE was commenced prior to the effective date of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010) (“Dodd-Frank”). Accordingly, the core principles cited above refer to Core Principles 10 and 17 prior to their amendment by Dodd-Frank. The Division notes that the substantive audit trail requirements of Core Principle 10 are unchanged by Dodd-Frank, while the recordkeeping requirements of former Core Principle 17 have been moved to a new Core Principle 18, as amended by Dodd-Frank. Accordingly, the Division’s review also incorporates elements of the Core Principles 10 and 18, as amended by Dodd-Frank.

Furthermore, on May 10, 2012, the Commission issued its Final Rules, *Core Principles and Other Requirements for Designated Contract Markets*, 77 Fed. Reg. 36612 (June 19, 2012) (“Final DCM Rules”), which became effective on October 17, 2012, to codify rules in lieu of guidance and acceptable practices for certain core principles, including new Core Principles 10 and 18. Although these Final DCM Rules were not in effect during the first or second target periods, the Division considered the changes to Part 38 in its review.

The Division's initial review revealed that CFE had a minimal audit trail enforcement program, which raised serious concerns regarding CFE's compliance with Core Principle 10. During the Division's on-site interview for the initial review on April 21, 2011, Division staff expressed its concerns regarding the Exchange's lack of an audit enforcement program and the Exchange promptly responded to the Division's concerns by committing to create and implement an audit trail enforcement program. CFE submitted a proposed audit trail enforcement program on July 11, 2011, which the Division found inadequate to demonstrate compliance with Core Principle 10. Accordingly, by letter dated November 4, 2011 ("November 4, 2011 letter"), the Division suspended its rule enforcement review of CFE, and requested, pursuant to its authority under Commission Regulation 38.5(b), that the Exchange demonstrate the form and manner of its compliance with the audit trail requirements under Core Principle 10. The letter also provided CFE a final opportunity to explain the measures it had taken or was prepared to take to achieve compliance with Core Principle 10, and to address deficiencies in the Exchange's audit trail program with respect to the following: (1) monitoring for potential recordkeeping or audit trail violations; (2) reviewing paper order tickets for orders that cannot be entered immediately upon receipt; (3) reviewing any sample front-end audit trail data; (4) monitoring for post-execution changes to trade information, such as account numbers or customer type indicator ("CTI") codes; (5) monitoring error account activity; (6) reviewing the accuracy of order entry data points; or (7) auditing, examining, and enforcing the proper assignment and usage of login IDs.

From January 10, 2012 through August 8, 2012, CFE worked to develop an audit trail enforcement program that addressed the concerns identified in the Division's November 4, 2011 letter and provided the Division with continuous updates on the progress it had made towards implementing such a program. The Division resumed its rule enforcement review of CFE on

August 15, 2012, and requested information to evaluate the audit trail program of CFE and its compliance with Core Principles 10 and 17, including the results of the audit trail enforcement program during the period from November 1, 2010 through August 1, 2012 (“second target period”). The Division commends the significant efforts undertaken by CFE to demonstrate its compliance with Core Principle 10 and believes that the program developed by the Exchange meets applicable requirements for an audit trail enforcement program. The Division further commends CFE for its commitment to enforcing the Exchange’s audit trail and recordkeeping requirements through its audit trail enforcement program.

II. Methodology

To evaluate the Exchange’s audit trail program and its compliance with the above core principles, Division staff interviewed compliance officials and staff from CFE and its regulatory services provider, the National Futures Association (“NFA”). The Division also received a demonstration of the electronic systems Exchange staff uses to perform audit trail enforcement. The Division also reviewed numerous documents created by both CFE staff and NFA staff on behalf of the Exchange, including the following:

- CBOE’s Regulatory Services Division Manual, CFE’s Investigation and Surveillance Procedures Manual (“CFE Manual”), Regulatory Circulars issued by the Exchange, and CFE’s Rulebook;
- Organizational charts and summaries of personnel and staffing;
- Meeting minutes of the Board of Directors and the Regulatory Oversight Committee (“ROC”) held during the first and second target periods;
- Computer reports and other outputs used routinely for audit trail enforcement;
- Audit trail investigations and examinations logs;

- Audit trail investigation and examination case reports and files; and
- The Regulatory Services Agreement (“RSA”) between the Exchange and NFA, which describes the scope of the self-regulatory services to be performed by NFA on behalf of the Exchange.

The Division provided CFE with an opportunity to review and comment on a draft of this report on July 25, 2013. On August 15, 2013, Division staff conducted an exit conference with Exchange officials to discuss the report’s findings and recommendations.

III. Summary of Findings and Recommendations

A. Findings

- During the first target period, CFE’s regulatory program was administered by the CBOE Member and Regulatory Services Division (“Regulatory Services Division”). As a result of a reorganization of the Regulatory Services Division in March 2012, CFE staff was separated into a discrete department – the Department of CFE Regulation (“CFER”). Consequently, the number of personnel solely dedicated to CFE regulation increased from one investigator to seven individuals, including a Chief Regulatory Officer (“CRO”), a Manager, and five investigators.
- CFER maintains a small but highly experienced staff. The CRO and CFE Manager have considerable experience in futures industry and compliance. The Exchange promptly increased staffing levels during the second target period in response to additional responsibilities undertaken by the Exchange with respect to implementing the audit trail enforcement program.
- The Exchange provides adequate training and education for its new hires and experienced staff, including specific training related to the audit trail enforcement program, the investigatory process and the surveillance tools used by staff.
- CBOE Command, 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, all order modifications and cancellations, and all matched trades. This record enables CFE to identify customer and market abuses and provide evidence of rule violations. Exchange staff can reconstruct trading through the Market Replay system, which provides a near real-time review of trading as it occurs on CBOE Command, as well as all archived data since trading began on CFE.
- As of April 30, 2012, the Exchange began requiring an Order Entry Operator ID (“OEO ID”) to identify the natural person or automated trading system (“ATS”) responsible for

entering the order or quote into CBOE Command. Exchange rules require that an OEO ID must not be associated with more than one natural person or ATS, and must be unique at the clearing firm-level. Trading Privilege Holders (“TPHs”) are responsible for assigning OEO IDs and must maintain and keep current certain identifying information regarding the natural person or ATS for which an OEO ID is issued.

- During the first target period, the Exchange had a minimal audit trail enforcement program, which did not include a review of TPHs’ compliance with audit trail and recordkeeping requirements. This raised serious concerns regarding the Exchange’s compliance with Core Principle 10. The Exchange promptly committed to developing and implementing an audit trail enforcement program that comprised of routine audit trail surveillance and annual examinations of every TPH.

The Division found that the Exchange’s audit trail enforcement program adequately implements the following: (1) monitoring for potential recordkeeping and audit trail violations; (2) reviewing paper order tickets for orders that cannot be entered immediately upon receipt; (3) reviewing sample front-end audit trail data; (4) monitoring for post-execution changes to trade information, including account numbers and CTI codes; (5) monitoring error account activity; (6) reviewing the accuracy of order entry data points; and (7) auditing, examining, and enforcing the proper assignment and usage of login IDs.

- The audit trail investigation and examination logs provided by the Exchange do not include open and closed dates that accurately reflect the actual time Exchange staff spent conducting examination or investigatory work on a matter. In particular, the Division found that: (1) the open date does not appear to reflect the date that staff began working on the matter; and (2) the Exchange does not maintain a discrete “pens down” date on which all examination and investigatory work conducted by staff was completed.
- The Exchange opened twelve audit trail investigations during the second target period, five of which were also completed during the second target period. Of the five completed investigations, three arose from CFER’s Multiple User/Single Account monthly review, while two arose from NFA referrals. Four of the completed investigations were “filed without action,”³ while one resulted in a Statement of Charges. All seven of the investigations that remained open after the second target period pertained to the Exchange’s routine audit trail surveillance.
- The Exchange opened 85 audit trail exams during the second target period, 25 of which were also completed during the second target period. Twenty of these 25 exams were filed without action, while five resulted in Letters of Caution⁴ issued to five separate

³ The Exchange uses the term “filed without action” to describe a matter that has been closed upon review and approval of CFE management.

⁴ The Exchange issues a Letter of Caution where a party violates a technical rule for the first time and it appears a letter is sufficient to prevent a recurrence. The letter serves as notice that another similar violation may result in a Statement of Charges.

TPHs. Thirteen of the completed exams were completed within 90 days, while the remaining 12 exams took between 91 and 279 days to complete.

- With respect to four exams that took between 144 and 279 days to complete, the Division is concerned that although work was steadily ongoing, these exams took an average of 207 days to complete.
- In four exams that took between 127 and 227 days to complete, the Division noted a prolonged and unexplained period of time where it appeared that no examination work related to the matter was being conducted, and no mitigating factors existed to warrant an average of 176 days to complete these exams.
- The Exchange's audit trail examination program resulted in the issuance of Letters of Caution to five separate TPHs during the second target period. Two TPHs received Letters of Caution for failing to maintain audit trail data, two for incorrect account origin code, and one for incorrect account origin code and failing to notify CFE of change in responsible trader.
- The Exchange issued a Statement of Charges for one audit trail investigation that arose from a NFA referral for improper CTI code usage. None of the investigations arising from the Exchange's monthly Multiple User/Single Account review, which was the only audit trail surveillance activity completed during the second target period, resulted in disciplinary action.
- The case reports for audit trail examinations do not include the date on which the report was approved by CFER staff or the signature of the approving senior CFER staff.
- The Division typically found the quality and documentation of the investigations and examinations work to be thorough and complete. With one exception, the Division generally found that the Exchange's actions, and its decisions whether or not to pursue disciplinary action, were appropriate.
- In one investigation involving a Subject TPH that submitted numerous orders with the incorrect CTI codes on behalf of its clients, at least nine of whom were also CFE TPHs, the Exchange took disciplinary action against the Subject TPH but did not take action against the client TPHs that were also found responsible for submitting incorrect CTI codes.

B. Recommendations

Although the Division believes that the Exchange maintains a generally adequate audit trail and audit trail enforcement program, the Division identified areas for improvement in response to certain findings listed above, and is making the following recommendations:

- All logs maintained by CFE should note the date that staff completed all examination and investigatory work related to a matter.

- CFE should include in its case report the date on which the report was approved by senior CFER staff and the signature of the approving senior CFER staff.
- CFE should continue to focus on reducing the time it takes to complete its annual audit trail examinations of TPHs.
- CFE should reduce the time it takes to complete audit trail investigations, including prompt review of the outputs generated by the automated systems used to conduct routine audit trail surveillance.
- CFE should promptly take appropriate disciplinary action when it identifies violations of its audit trail or recordkeeping requirements by persons subject to CFE's rules. At a minimum, CFE should remind persons subject to its rules of their continuing compliance obligations even when services are received from third parties

IV. CFE Operations

A. Designation as a Contract Market

CFE was created as a wholly-owned subsidiary of the Chicago Board Options Exchange, Inc. ("CBOE").⁵ CFE, which was designated as a contract market by the Commission in August 2003, was created to offer automated trading on futures and options on futures contracts based on volatility and variance indices. Trading on CFE began on March 26, 2004. CFE contracted with the Options Clearing Corporation ("OCC") for clearing and settlement service for all futures transactions conducted on the Exchange. CFE is also notice registered as a National Securities Exchange with the Securities and Exchange Commission for the purposes of trading securities futures products.

All trading on CFE is electronic on CBOE's trading platform, CBOE Command.⁶

Individuals and organizations that wish to trade on CFE must apply to become TPHs.

Individuals and organizations applying for trading privileges on CFE can be further classified as

⁵ As discussed in Section IV(B)(1), CBOE demutualized in 2010 and converted to a holding company structure. Consequently, CFE, CBOE and other CBOE affiliates became wholly-owned subsidiaries of CBOE Holdings, Inc.

⁶ CBOE Command also supports trading on CBOE, C2 Options Exchange, CBOE Stock Exchange and OneChicago.

those with existing trading privilege on CBOE (“CBOE TPHs”), and those without existing trading privileges on CBOE (“non-CBOE TPHs”). CBOE TPHs do not need to satisfy any additional criteria to obtain trading privileges on CFE, so long as they are not subject to any statutory disqualifications, are registered or otherwise permitted by the Commission and/or NFA to conduct business on the Exchange and are guaranteed by a clearing member.⁷ Conversely, non-CBOE TPHs must submit an application for trading privileges,⁸ which may be denied on the same basis for which NFA may deny or revoke a Futures Commission Merchant’s (“FCM”) registration.⁹ As of December 2012, CFE had 109 TPHs, 75 of which were also CBOE TPHs.

B. CFE Governance

1. *Ownership and Board of Directors*

As stated above, CFE was created as a wholly-owned subsidiary of CBOE. On June 18, 2010, CBOE demutualized and converted to a holding company structure, at which time CFE became a wholly-owned subsidiary of CBOE Holdings, Inc. (“CBOE Holdings”). Other CBOE Holdings subsidiaries include: CBOE, CBOE Stock Exchange (“CBSX”),¹⁰ C2 Options Exchange (“C2”), and Market Data Express, LLC (“MDX”).

CBOE Holdings, as sole shareholder of CFE, elects the CFE Board of Directors. The Boards of Directors for CBOE Holdings and CFE are independent of each other and carry out different functions. During the first and second target periods, the Boards of CBOE Holdings and CFE consisted of different directors that did not overlap between the two boards.¹¹ The CBOE Holdings’ Board is concerned with macro-level issues related to the public company,

⁷ CFE Rule 304.

⁸ CFE Rule 305.

⁹ Such reasons include that the applicant (1) is unable to demonstrate an ability to adhere to all applicable rules of the Exchange, OCC and Commission Regulation; (2) would bring the Exchange into disrepute; or (3) for such other cause as the Exchange may reasonably deny. CFE Rule 304.

¹⁰ CBOE holds a 49.96% interest in CBSX.

¹¹ As of May 23, 2013, the individual serving as Chairman of the CFE Board became a member of the CBOE Holdings Board.

while CFE's Board is focused solely on Exchange-specific issues. During the first target period, CFE's Board consisted of five directors, including two public directors, which satisfied the thirty-five percent standard set forth in the Acceptable Practices for Core Principle 16.¹² On September 19, 2012, CFE expanded its board to include an additional public director and an additional market participant, for a total of seven board members. As a result of this change, CFE's Board is currently comprised of three public directors, three market participant directors, and one managing director.¹³

2. *Regulatory Oversight Committee*¹⁴

CFE's self-regulatory program is overseen by the ROC, a Board-level committee comprised of the Exchange's three public directors. The Exchange's ROC was created on April 26, 2010. The ROC's charter outlines the responsibilities, functions, authority and composition of the committee, all of which are modeled after the Acceptable Practices for Core Principle 16. To conduct oversight of the Exchange's regulatory program, including the regulatory services provided by NFA, the charter confers upon the ROC specific responsibilities, such as monitoring the Exchange's regulatory program for sufficiency, effectiveness, and independence; overseeing all facets of the regulatory program; supervising the CRO; and recommending changes that would ensure fair, vigorous, and effective regulation. Additionally, the ROC is responsible for reviewing the size and allocation of the regulatory budget, and evaluating regulatory proposals and advising the Board as to whether and how such changes may impact regulation. On an annual basis, the ROC must prepare a report assessing the self-regulatory program of the

¹² Dodd-Frank renumbered former Core Principle 15, *Conflicts of Interest*, to new Core Principle 16. The Acceptable Practices adopted for the core principle, both prior to and after its amended by Dodd-Frank, state that "[a]t least thirty-five percent of the directors on a contract market's board of directors shall be public directors."

¹³ Currently CFE's public directors consist of approximately 43 percent of the total number of directors.

¹⁴ The discussion relating to the ROC is solely to increase the understanding of the operations of the ROC and CFE's overall regulatory program. This review does not contain any judgments with respect to the Exchange's compliance with Core Principle 16, as amended by Dodd-Frank.

Exchange for the Board and the Commission. The ROC's responsibilities go beyond the Acceptable Practices for Core Principle 16 to include overseeing compliance functions and supervising the Chief Compliance Officer.¹⁵ Finally, the ROC reviews decisions by the Business Conduct Committee ("BCC") not to issue Statements of Charges that were recommended by Exchange staff and may bring such decisions to the Board's attention.

The CRO meets with the ROC at least three times a year to give the committee a formal presentation about the status of CFE's compliance program. These presentations summarize the activities performed for the Exchange by NFA and highlight the status of any pending investigations and disciplinary proceedings. CFE staff members provide summaries of any new product offerings and CFE rule changes. The ROC is also informed of any proposals and rulemakings issued by the Commission and their impact on CFE. During the course of the Division's rule enforcement review, CFE staff provided the ROC periodic updates regarding the status of the review, including the actions CFE was taking with respect to its audit trail program to address the issues and recommendations identified by the Division. Finally, the CRO makes an annual budget recommendation to the ROC, and once reviewed and approved by the ROC, it is presented to the full Board for approval.

C. Regulatory Services Provided by NFA

As discussed above, CFE has contracted with NFA to provide certain regulatory services to the Exchange pursuant to an RSA. According to the RSA, NFA is responsible for performing trade practice and market surveillance on behalf of the Exchange, as well as conducting most of the investigatory work relating to trade practice and market surveillance. Although the Exchange is primarily responsible for conducting real-time market monitoring, it provides NFA with a view-only market supervision screen of CFE's markets. On the monthly basis, NFA is required

¹⁵ The ROC's charter was amended on September 19, 2012 to include these functions.

to prepare for the Exchange’s review reports detailing the number and type of exception reports generated. Furthermore, NFA must provide the Exchange with a monthly report specifying the number of inquiries and investigations commenced, the status of the each investigation, and the nature of the violations alleged to be found. NFA does not perform any audit trail-related services on behalf of the Exchange.¹⁶ During the first and second target periods, NFA had executed agreements to provide similar regulatory services for other U.S. futures exchanges, including ELX Futures, NYSE Liffe U.S., Chicago Climate Futures Exchange, NASDAQ OMX Futures Exchange (“NFX”), Eris Exchange and trueEx.¹⁷

D. Products and Trading Volume During the First and Second Target Periods

CFE offered four futures contracts during the first target period: CBOE Volatility Index (“VIX”) Futures (“VX”), CBOE Mini-VIX Futures (“VM”), CBOE S&P 500 Twelve-Month Variance Futures (“VA”), and CBOE S&P 500 Three-Month Variance Futures (“VT”). CFE also introduced its first options contract during the first target period – the Weekly Options on CBOE VIX Futures (“VOW”). Subsequently, the Exchange launched security futures contracts on the CBOE Gold ETF Volatility Index (“GV”) and futures on a Radar Logic 28-Day Real Estate index (“RPX”) during the second target period. CFE continued to expand its volatility index futures offerings to include CBOE Nasdaq-100 Volatility Index (“VXN”) futures, as well as security futures on various sector-specific ETF and single-stock VIX products. However, the VIX futures contract has remained the Exchange’s leading product.

¹⁶ As discussed further in section VI(B)(3), the Exchange utilizes an alert generated as part of NFA’s trade practice surveillance program to identify instances where multiple CTI codes are utilized by a single account on a given trade date in its audit trail enforcement program.

¹⁷ NFA ceased providing regulatory services for Chicago Climate Futures Exchange on December 31, 2010.

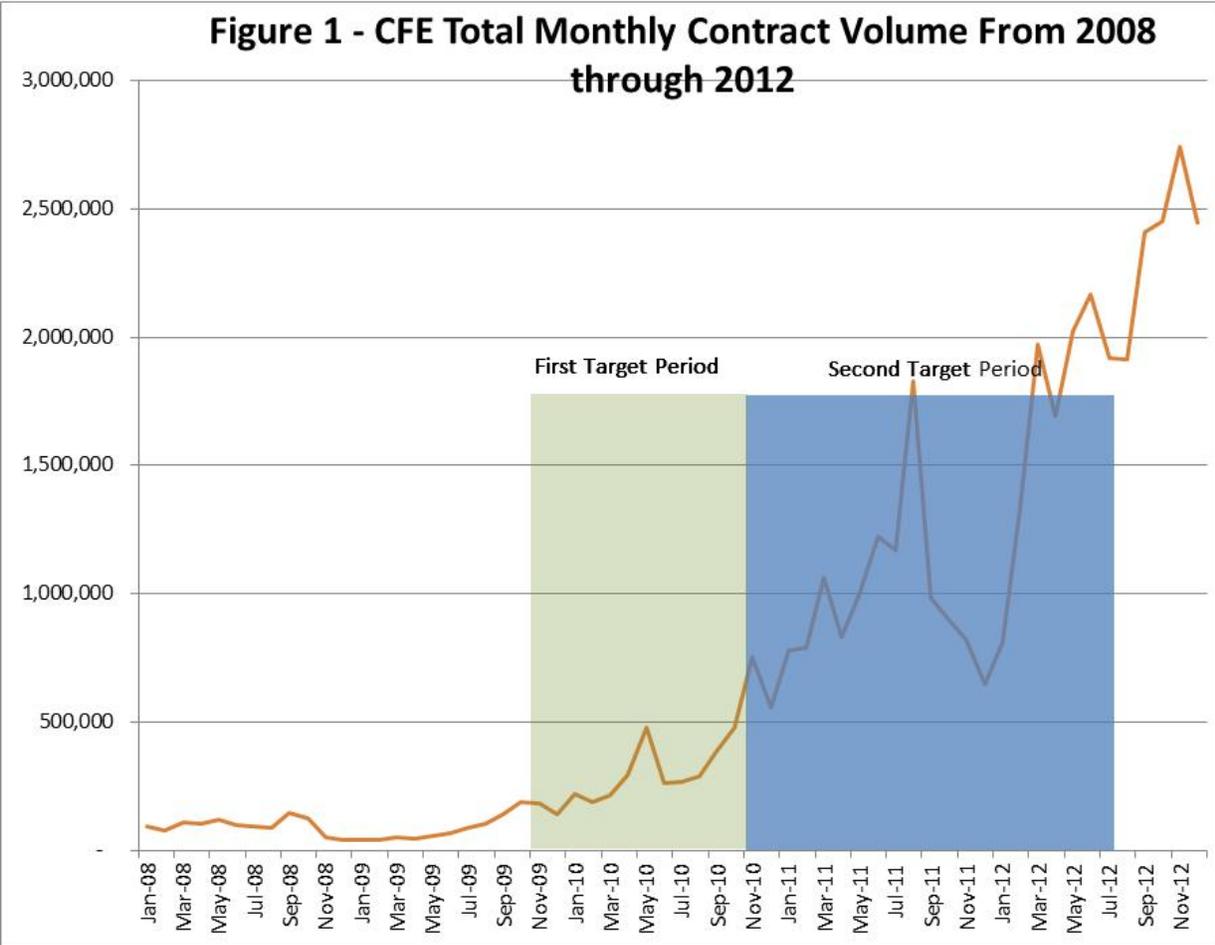


Figure 1 illustrates CFE’s total monthly contract volume from January 2008 through December 2012. Trading volume was relatively stable until it began steadily increasing in late 2009. Volume grew from 1.2 million contracts in 2009 to 4.4 million contracts in 2010, and then nearly tripled to 12 million contracts in 2011. In 2012, trading volume reached 23.8 million contracts, an increase of 98 percent from the preceding year. Ninety-nine percent of this volume can be attributed to the Exchange’s trademark product, the VIX futures contract.

V. Staffing, Organization and Training

During the first target period, CFE’s regulatory program was administered by the CBOE’s Regulatory Services Division, which was also responsible for regulatory programs of

other CBOE entities, including CBOE, CBSX, and C2.¹⁸ The Regulatory Services Division was led by a CRO, who held this title across all CBOE entities. The following five departments comprised the Regulatory Services Division: the Department of Member Firm Regulation, the Department of Market Regulation, the Department of Regulated Entities, the Department of Information Access and Development, and the Department of Regulatory Planning and Strategy.

The Department of Regulated Entities (“DRE”) was tasked with carrying out the investigatory programs of CFE, CBSX, and the Options Regulatory Surveillance Authority (“ORSA”).¹⁹ For CFE, this included all trade practice and market surveillance activities that NFA did not conduct on behalf of the Exchange. During the first target period, DRE staff dedicated to CFE regulation consisted of the CRO who spent between approximately ten to fifteen percent of his time on CFE matters, one director who spent approximately twenty-five percent of her time on CFE matters and the remainder of her time on CBSX and ORSA matters, one director who spent approximately half of his time on CFE matters and the other half on CBSX matters, and a chief investigator who was solely dedicated to CFE matters. Additional DRE staff was available to assist in CFE regulatory matters should the need arise.

In March 2012, the Regulatory Services Division was reorganized and CFE staff was separated into a discrete department within the Regulatory Services Division, creating the Department of CFE Regulation (“CFER” or “Department”).²⁰ As of December 2012, CFER consisted of seven fully dedicated personnel, including a CRO, a Manager, and five

¹⁸ All Regulatory Services Division personnel are dually employed by CBOE and CFE.

¹⁹ ORSA is responsible for conducting insider trading investigations related to options on behalf of all options exchanges. CBOE is the Regulatory Services Provider (“RSP”) for ORSA.

²⁰ The reorganization also separated ORSA staff into a new department, reorganized the Department of Market Regulation, and created an Office of the CRO. Additionally, the Office of Enforcement moved from the Legal Division to the Regulatory Services Division.

investigators. CFER is led by a highly-experienced CRO who is solely dedicated to CFE.²¹ The CRO's responsibilities include overseeing the Exchange's regulatory program and managing NFA as its regulatory services provider. The CRO reports directly to the ROC, but is also managed administratively by the Senior Vice President of the Regulatory Services Division.²² The CRO is assisted by a Manager,²³ whose responsibilities include the day-to-day management of the Department, such as selecting, training and supervising Department staff; implementing any new requirements mandated by new CFE, CFTC or SEC rules; and conducting special projects as assigned. CFER investigators are responsible for conducting investigatory work related to the Exchange's regulatory program. Market surveillance responsibilities including conducting daily real-time surveillance, monthly preliminary reviews of security futures quoting obligations for market-makers, monthly security futures settlement review, monthly VIX expiration review, and position accountability surveillance. While most of the trade practice surveillance is performed by NFA, Exchange staff remains responsible for reviewing NFA referrals and conducting any additional investigatory work as needed. However, the bulk of the investigators' time is spent on the Exchange's audit trail program. Since implementation of the program, investigators have been dedicating approximately three-quarters of their time to conducting audit trail exams. Finally, investigators also support the Office of Enforcement throughout various stages of the disciplinary process and may act as an expert witness in disciplinary hearings.

One of the five investigator positions was added in response to a backlog of examinations that developed while the Exchange was hiring and training staff to administer the new audit trail

²¹ The CRO has 32 years of financial markets experience and has served in various roles within the CBOE organization.

²² The Senior Vice President of the Regulatory Services Division also serves as the CRO for CBOE, CBSX and C2.

²³ The CFE Manager has 13 years of futures compliance experience.

examination program. CFER further intends to add a staff position for an individual who will be dedicated to calculating margin requirements and conducting financial surveillance for the Exchange.

In addition to the seven individuals dedicated to its regulatory program, CFER receives support from other groups within the Regulatory Services Division, the Legal Division, and the Trading Systems Development Division.

- The Legal Division, which is led by a general counsel who serves this position for CFE and CBOE, provides legal support for the Exchange. Two attorneys within the Legal Division handle all legal matters on behalf of the Exchange, including rule filings and interpretations.
- The Office of Enforcement, which moved to the Regulatory Services Division from the Legal Division as part of the reorganization, includes two attorneys who are responsible for CFE's enforcement program, which includes handling all aspects of the enforcement process before the BCC and resolving disciplinary matters on behalf of the Exchange.
- Department of Member Firm Regulation supports CFE in conducting financial reviews of TPHs;
- The Information Access and Development ("IAD") group, which is housed in the Office of the CRO, develops and supports surveillance tools and reports and provides ad hoc reports upon request by Exchange staff;
- CFE Help Desk, which resides in Trading Systems Development Division, accepts and monitors off-exchange transactions, such as Exchange of Contract for Related Position transactions and block trades.

CFER staff meets on a weekly basis to review completed exams and investigations and other routine matters. The weekly meeting also provides an opportunity to discuss any new rules, policies and procedures, as well as new product launches or changes to Exchange trading procedures. Topics that are more complex or require lengthy discussion are addressed at a separate meeting to ensure that sufficient time is provided. CFER staff also attends a monthly “Pre-BCC meeting” which is a meeting of all of the departments within the Regulatory Services Division to review the cases that will be presented at the next BCC meeting.

The Exchange has an annual training requirement of eight hours for all staff, including training regarding self-regulatory organization (“SRO”) obligations and staff’s responsibilities under Exchange policies as employees of SROs and entities that are owned by a public company. CFE offers new hire training which consists of general orientation as well as on-the-job training and specific training relating to the investigatory process and the surveillance tools used by staff. During the second target period, staff attended training sessions that focused on the audit trail exam program. In addition, CFE staff attended training led by OCC addressing trade allocations, adjustments and transfers, and training from the Options Institute covering exchange traded funds and exchange traded notes that are based on the VIX.

The Division believes that the CFER personnel are qualified and experienced. The Exchange provides adequate training and education for its new hires and experienced staff, including training pertaining to the audit trail enforcement program. The Exchange promptly increased staffing levels during the second target period in response to additional responsibilities undertaken by the Exchange with respect to implementing its audit trail enforcement program. Based on the foregoing, the Division has no recommendations in this area.

VI. Audit Trail Program

Former 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.

Former 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.

New 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–

- (A) to assist in the prevention of customer and market abuses; and**
- (B) to provide evidence of any violations of the rules of the contract market.**

New Core Principle 18 – Recordkeeping

The board of trade shall maintain records of all activities relating to the business of the contract market –

- (A) in a form and manner that is acceptable to the Commission; and**
- (B) for a period of at least 5 years.**

The audit trail requirements under the Final DCM Rules are consistent with previous guidance issued by the Division in rule enforcement reviews and the guidance and acceptable practices found in Part 38 of the Commission’s regulations prior to its amendment.²⁴ Therefore, a designated contract market’s (“DCM”) obligations with respect to its audit trail program remain largely unchanged. A DCM must capture and retain sufficient audit trail data to detect, investigate, and prevent customer and market abuses and to reconstruct transactions within a

²⁴ Although the Final DCM Rules were not in effect during the first or second target periods, the Division considered the changes to Part 38 and the Act in its review. See supra note 2.

reasonable period of time. In addition, the DCM 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.²⁵

The Final DCM Rules codified certain guidance regarding an exchange's audit trail enforcement program previously issued by the Division through its rule enforcement reviews. These requirements include annual audit trail and recordkeeping reviews of all members and persons and firms subject to the DCM's recordkeeping rules to enforce compliance with the DCM's audit trail and recordkeeping requirements. Audit trail reviews must include the following: (1) review of randomly selected sample front-end audit trail data; (2) review of the process by which user identifications are assigned and records relating to user identifications are maintained; (3) review of the usage patterns of user identifications to identify violations of user identification rules; and (4) review of account numbers and customer type indicator codes for accuracy and proper use. In addition, DCMs must develop programs to ensure effective enforcement of their audit trail and recordkeeping requirements, which includes the ability to identify members and market participants that routinely failed to comply with Core Principle 10

²⁵ 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 customer type indicator code; timing and sequencing data adequate to reconstruct trading; and the identification of each account to which fills are allocated. An electronic analysis capability with respect to all audit trail data in the transaction history database permits the DCM to reconstruct trading and 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. Since the Division conducts separate examinations of DCMs' compliance with the safe storage requirements, 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*.

and to levy meaningful sanctions when deficiencies are found. Sanctions must not include more than one warning letter or other non-financial penalty for the same violation within a rolling twelve month period.

Finally, the recordkeeping requirements under the Final DCM Rules continue to require that all books and records, including trade records and investigatory and disciplinary files, must be maintained for five years and be readily accessible during the first two years.

A. Order Entry and Creation of Electronic Audit Trail

1. Trading Platform Order Entry Systems and Process

Only individuals or organizations that hold trading privileges on the Exchange (i.e., that are TPHs) may enter orders directly to CBOE Command; those that do not hold privileges must trade through a TPH. Individual TPHs can use their trading privileges to trade their proprietary accounts or to execute trades on behalf of customers. Organizations with trading privileges on the Exchange include proprietary trading firms; retail brokerage firms and futures commission merchants (“FCMs”); and executing brokerage firms. To become a clearing firm, a TPH must become a member of CFE’s clearinghouse, OCC. Any TPH that is not also a member of OCC must have a clearing firm guarantee in place to access CBOE Command. As of December 2012, 28 of CFE’s 109 TPHs were also members of OCC.

TPHs can directly access CBOE Command by utilizing their own proprietary interface, through front-end systems provided by Independent Software Vendors (“ISV”), or by writing directly to one of the application programming interfaces (“APIs”), such as the Financial Information Exchange (“FIX”) or CBOE Market Interface (“CMi”). To place an order on CBOE Command, a TPH must log into the system with its assigned user identification and password (collectively, “CFE login” or “login”). CBOE Command will not accept an order that does not

meet the following three conditions: (1) contains a valid CFE login; (2) placed from an IP address that matches the IP address on file with the Exchange, and (3) contains the information required for all orders. In addition, risk controls implemented by the Exchange in October 2012 impose pre-trade order size limits and price reasonability checks prior to the execution of transactions on CBOE Command.²⁶

All orders transmitted to CBOE Command must include the product, executing firm, buy sell code, quantity, price, the time in force, account name, open close code, CBOE account type, and expiration date. The CTI code is populated in the Exchange’s audit trail via the CBOE account type code, which is subsequently translated into the equivalent CTI and origin codes.²⁷

²⁶ These risk controls include rejection of off-market limit orders that exceed a defined price away from the market and market order protection checks that reject market orders when the bid/ask spread is greater than a pre-defined width.

²⁷ The Exchange defines the CTI codes as follows:

CTI 1- Transactions initiated and executed by an individual TPH for the TPH's own account, for an account the TPH controls, or for an account in which the TPH has an ownership or financial interest.

CTI 2- Transactions executed for the proprietary account of a clearing member or non-clearing member TPH.

CTI 3- Transactions where an individual TPH or authorized trader executes for the personal account of another individual TPH, for an account the other individual TPH controls or for an account in which the other individual TPH has an ownership or financial interest.

CTI 4- Any transaction not meeting the definition of CTI 1, 2 or 3.

The translation of the CBOE account type to CTI code and Options Clearing Corporation (“OCC”) account type occurs as follows:

CBOE Account Type	CTI Code	OCC Account Type (“Origin Code”)
D (FIX Interface)	1	Customer
V (CMi Interface)	1	Customer
E	1	Firm
F	2	Firm
O	2	Customer
M	2	Market Maker
A (FIX Interface)	3	Customer
G (CMi Interface)	3	Customer
H	3	Firm
C	4	Customer
L	4	Firm

The origin code identifies whether an order clears in the customer, firm or market maker range at OCC. Market maker quotes and orders are populated with the CBOE account type based upon the profile established for that TPH, while non-market makers must enter the CBOE account type at the time of order entry. Additionally, all orders for options must also include the strike price, whether the option is a put or call, and the expiration month. As of April 30, 2012, the Exchange began requiring an Order Entry Operator ID (“OEO ID”) with every order or quote submitted.

For any order that cannot be immediately entered into CBOE Command, the Exchange rules require the TPH to prepare an order ticket in “a non-alterable written medium, which shall be time-stamped and include the account designation, date, and other required information.”²⁸

An order ticket must be retained for at least five years from the time that it was prepared, and the order must be entered sequentially into CBOE Command as soon as it can be entered.²⁹

Furthermore, each TPH is responsible for maintaining front-end audit trail information for all electronic orders entered into CBOE Command, including “all order entry, modification, cancellation, and response receipt time(s) as well as all FIX tag information and fields or CMi order structure, as applicable.”³⁰ Exchange rules require TPHs to maintain all books and records for five years, and have such books and records readily accessible for the most recent two years.³¹

CBOE Command executes orders based on the allocation method set for that product – either price-time priority or pro rata priority.³² Once the trade has been executed, CBOE

²⁸ CFE Rule 403(b).

²⁹ *Id.*

³⁰ CFE Rule 403(c).

³¹ CFE Rule 502.

³² The price-time method prioritizes orders at the best price in the order in which they were received, while the pro rata method prioritizes orders at the best price on a pro rata basis. In addition to these base allocation methods, CFE rules permit it to overlay certain priorities. The public customer priority prioritizes orders place by or on behalf of a

Command transmits a trade confirmation to the initiating TPH through the originating network and sends a copy of the trade to its trade match system, Continuous Trade Match (“CTM”). CTM then submits those trades near real-time to OCC for clearing and settlement. Post-execution changes to trades can only be made by using OCC’s Trade Management System and are limited to the following fields: account name and subaccount name, order ID, CMTA firm code,³³ and CBOE account type. These changes appear in the audit trail as allocations or transfers. OCC reports any changes made prior to the end of the business day to the Exchange, and these changes are included in the audit trail data transmitted to NFA. Any changes that occur after the trade day are sent to directly to NFA from OCC.

CBOE Command creates a comprehensive audit trail by automatically recording all messages entered into the system. The retained information includes all orders, including all modifications, cancellations, and all responses by the system to such messages, and all trades matched by the system. It also includes all quotes submitted by market makers. Every action with respect to an order or execution is time-stamped to the millisecond. A complete record of all trade and market data is entered into the Consolidated Database (“CDB”), which replicates all trading activity on a near real-time basis. Once logged into the CDB database, the data is then transmitted it to the CBOE data warehouse, which is used to store, retrieve and manage the audit trail data. The data warehouse loads the audit trail data into database tables and stores the data on archive servers. The system does not allow TPHs or Exchange staff to erase or alter any messages from the audit trail. Exchange staff can access the audit trail data through the Market

public customer over orders place by or on behalf of non-public customers. Furthermore, the market turner priority permits a TPH or its authorized trader who enters an order or quote at a price that is better than the best price previously available, to retain priority at the highest bid or lowest offer made by it. Finally, the Exchange also provides designated primary market makers (“DPMs”) certain trade participation rights.

³³ This field represents the give-up firm, the firm for whom the trade was executed for by the executing firm. The CMTA is an agreement between two OCC Clearing Members allowing one Clearing Member to execute trades on an exchange for another Clearing Member. The executing Clearing member indicates on its trade entry that it wishes to give-up the trade to another Clearing Member. Valid CMTA trades clear and settle in the give-up firm’s account.

Replay system, which is a front-end system that accesses the CDB database, to view near real-time trading as it occurs on CBOE Command, as well as all archived data since trading began on CFE.

Once CFE receives cleared trade data from OCC overnight, the Exchange formats and electronically transmits the audit trail records to NFA. As discussed, the audit trail data provided to NFA includes any post-execution changes made prior to the end of the business day, while changes that occur after the trade day are provided directly from OCC. The records are processed overnight through NFA's system and are available the following business day, on a trade date plus one ("T+1") basis. NFA populates the CTI code in the Exchange's audit trail data by translating the CBOE account type to the equivalent CTI and origin codes.

2. Identification of "Authorized Traders"

Each TPH may designate one or more natural persons as its "authorized trader" for purposes of accessing CBOE Command.³⁴ As a practical matter, organizations with trading privileges must assign an authorized trader, whereas individual TPHs may themselves act as the authorized trader. Exchange rules require that each TPH must ensure that none of its authorized traders are subject to any statutory disqualification and that each of its authorized traders is technically proficient and conducts its business in a fair and equitable manner.³⁵ Each trading permit entitles its holder up to three CFE logins to access CBOE Command. During the first target period, the Exchange rules did not require TPHs to assign a unique CFE login for each of its authorized traders. Therefore, TPHs could permit multiple authorized traders to use a single

³⁴ CFE Rules 105 and 303.

³⁵ CFE Rule 303.

CFE login, so long as the TPH maintained a record of the authorized trader responsible for a given order, bid, offer, or other message transmitted to CBOE Command.³⁶

As of April 30, 2012, the Exchange rules require that each natural person who enters an order into CBOE Command must have and enter an OEO ID that identifies the individual physically responsible for entering the order or quote into CBOE Command.³⁷ Each Automated Trading System (“ATS”) that generates and routes an order to CBOE Command must also submit an OEO ID for that ATS.³⁸ Exchange rules require that an OEO ID must not be associated with more than one natural person or ATS.³⁹ Each TPH is responsible for assigning OEO IDs and ensuring that the OEO ID is unique at the clearing firm level.⁴⁰ TPHs are also required to maintain and keep current the following information for each OEO ID assigned to a natural person or ATS: name; business address; business telephone; business email; and position or relationship to the TPH of the natural person, or if the OEO ID is issued to an ATS, the head operator of the ATS.⁴¹

3. Identification of “Responsible Traders”

CFE rules require each TPH to designate a “responsible trader” as its administrator with respect to the TPH’s use of CBOE Command.⁴² Responsible traders designated by non-CBOE TPHs must undergo a background investigation by CFE’s Registration Services Department. Once designated, responsible traders have full control over access to CBOE Command by the TPH and its authorized traders and have the ability to access, and, if required, modify and

³⁶ CFE Rule 501(b).

³⁷ CFE Rule 303A.

³⁸ CFE Rule 303A(c).

³⁹ CFE Rule 303A(b).

⁴⁰ CFE Rule 303A(d).

⁴¹ *Id.*

⁴² CFE Rule 513(a).

withdraw, any and all orders placed by such TPH and its authorized traders.⁴³ TPHs are encouraged to designate more than one responsible trader to allow for sufficient back-up.

4. Findings and Recommendations Regarding Order Entry and Creation of Electronic Audit Trail

The Division believes that CFE maintains an adequate audit trail. 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. CBOE Command creates a comprehensive audit trail by automatically recording all messages entered into the system, including all orders, including all modifications, cancellations, and all responses by the system to such messages, and all trades matched by the system. The system does not allow TPHs or Exchange staff to erase or alter any messages from the audit trail. Exchange staff can reconstruct trading through the Market Replay system, which provides a near real-time review of trading as it occurs on CBOE Command, as well as all archived data since trading began on CFE. As of April 30, 2012, Exchange rules require that each natural person who enters an order into CBOE Command must have an OEO ID that identifies the individual physically responsible for entering the order or quote. Each ATS that generates and routes orders to CBOE Command must also submit an OEO ID for that ATS. Based on the foregoing, the Division has no recommendations in this area.

B. Audit Trail Enforcement

As discussed in Section I, the Exchange did not review TPHs' compliance with audit trail and recordkeeping requirements during the first target period. To address this deficiency and the concerns expressed in the Division's November 4, 2011 letter, CFE implemented a comprehensive audit trail enforcement program. As part of the new audit trail enforcement

⁴³ Id.

program, the Exchange conducts audit trail investigations to investigate potential violative activity arising from CFE's routine audit trail surveillance or NFA referral, as well as annual audit trail exams of every TPH to ensure compliance with Exchange's audit trail and recordkeeping requirements.

1. Audit Trail Routine Surveillance and Reviews

The Exchange's audit trail surveillance program primarily relies on three reports created by IAD. These reports enable staff to identify unusual or potential violative activity relating to the Exchange's audit trail requirements. First, Exchange staff conducts an Order Entry Operator review ("OEO review") to identify every instance in which an order is received without the presence of the OEO ID.⁴⁴ Exchange staff has been conducting this review since June 2012 by using a monthly report generated by IAD to identify the total number of trades submitted without an OEO ID by a given TPH. Investigators can submit an ad-hoc request to IAD for the trade details for each trade submitted without an OEO ID. Generally, the OEO review for a given month is assigned to an investigator within two weeks after the month's end. The investigator reviews and summarizes the results of the review in a case report, along with a recommendation to either initiate a separate investigation for any TPH that submitted trade without an OEO ID or to file the matter without action if no such orders are found. If an audit trail exam of the TPH is already underway, the Exchange may choose to address the matter in the exam rather than in a separate investigation. With the adoption of its summary fine program described below, Exchange staff will identify TPHs that have failed to provide OEO IDs for trades in a given month and levy fines according to the fine schedule.⁴⁵

⁴⁴ Since CBOE Command will not reject orders or quotes that do not populate this field, the Exchange uses this surveillance report to enforce the requirement that an OEO ID must be included in every order submitted.

⁴⁵ See *infra* section VI(B)(4) for a discussion of the summary fine program.

Second, as of September 2011, the Exchange began conducting a Multiple User/Single Account review to enforce the proper assignment and usage of CFE logins. This review uses two reports – a report that identifies trading by a single login on behalf of an unusually large number of accounts, and a report that identifies trading by an usually large number of CFE logins on behalf of a single account.⁴⁶ Generally, the Multiple User/Single Account review for a given month is assigned to an investigator within the first two weeks of the month’s end. The investigator generates both reports for a given date or range of dates. Since the results of these reports will not indicate, in and of themselves, unusual trading or potential violations of Exchange rules, investigators analyze the overall trend for a given month for each account, in addition to trading that exceeds certain pre-determined threshold, to identify unusual trading by an account. The investigators contact the TPH to whom any unusual trading is attributed and verify that the CFE logins identified were authorized to trade on behalf of the account. Once this inquiry is completed, the investigator summarizes the findings of this review in a case report, along with a recommendation to either initiate a separate investigation of any TPH for which unusual trading was identified or to close the matter without action if no unusual trading is found.

Third, Exchange staff conducts an Invalid TPH review to identify any trades placed on CFE by a non-TPH, as proscribed by Exchange rules. The Exchange implemented this review in April 2012 to ensure that a technology malfunction or other system error does not permit access to an individual who does not hold Exchange trading privileges. On a daily basis, IAD generates a report for Exchange staff that identifies whether any non-TPHs accessed the CFE directly and

⁴⁶ The Exchange will expand its use of this tool to identify trading by a single OEO ID on behalf of an unusually large number of accounts and trading by an usually large number of OEO IDs on behalf of a single account. The Exchange has started using this tool to identify unusual or violative activity with respect to OEO IDs during its audit trail exams.

traded the previous day. If trading by a non-TPH is identified, investigators submit a high-priority request to IAD to obtain additional information and notify CFER management of the activity. While these results are reviewed daily by all CFER investigators, one investigator is responsible for creating a case report summarizing the results of the review at the end of the month.

2. TPH Audit Trail Examination Program

As part of its audit trail examination program, the Exchange conducts annual reviews of its TPHs to verify that all required audit trail data has been accurately recorded, submitted and maintained. Investigators are assigned audit trail exams on a monthly basis, pursuant to the annual audit trail examination schedule established by the Department. The investigator commences the exam by sending an advisory letter notifying the TPH that an exam has been initiated to review its audit trail recordkeeping procedures. The advisory letter also requests certain information from the TPH, including written supervisory procedures regarding the TPH's audit trail recordkeeping practices, error account procedures, sample audit trail records, a list of OEO IDs and account numbers belonging to the TPH, and paper order tickets, if applicable. Although the exam focuses on a two-month period, investigators can expand the review period if it appears that a TPH is not adequately maintaining the requisite audit trail data or for other related issues.

CFE investigators conduct the audit trail examinations in accordance with the audit trail exam module outlined in the CFE Manual. The exams include the following components: (1) obtaining and verifying TPH membership and ownership information; (2) reviewing sample front-end audit trail data and paper order tickets; (3) reviewing the accuracy of order entry data points; (4) monitoring for post-execution changes to CTI codes and account numbers; (5)

monitoring error account activity; (6) reviewing adjustments and transfer activity; and (7) reviewing compliance with OEO ID requirements. These components are discussed further below.

i. Obtaining and Verifying TPH Membership and Ownership Information

Investigators begin the exam by gathering background information on the TPH by searching the CBOE Trading Permits System (“TPS”), a database that identifies the TPH’s membership types, primary contact information, name of responsible trader(s), as well the CFE logins assigned to the TPH. Investigators also use the Back Office Reporting System (“BORS”), to view the registration history for each CFE logins assigned to the TPH. Together, these systems enable the investigators to identify how the TPH accesses the Exchange and verify this information against the records provided by the TPH. Additionally, investigators query NFA’s BASIC,⁴⁷ FINRA’s WebCRD,⁴⁸ and SEC reports to verify ownership and management information provided by the TPH.

ii. Reviewing Sample Front-End Audit Trail Data and Paper Order Tickets

Investigators review the TPH’s written supervisory procedures to determine if they are sufficient to maintain accurate and complete audit trail records in accordance with Exchange rules and Commission regulations. To verify that the TPH is maintaining the data in accordance with its procedures, investigators review a sample of the TPH’s paper order tickets, if any such order tickets were created during the review period, to ensure they are accurate and complete, and were created and maintained pursuant to Exchange rules. For all orders placed electronically, investigators review a subset of trades executed on sample trade dates over the

⁴⁷ BASIC, which stands for Background Affiliation Status Information Center, contains CFTC registration and NFA membership information, as well as all regulatory and non-regulatory actions taken by NFA, the CFTC and the U.S. futures exchanges.

⁴⁸ WebCRD contains the registration information on registered broker-dealers and the qualification, employment, and disclosure history of individuals registered with FINRA.

last five years to ensure that audit trail data is in a standard format, that the record includes all orders placed but rejected for any reason, and that each order contains the required fields.⁴⁹

iii. Reviewing the Accuracy of Order Entry Data Points

To verify the accuracy of order entry data points, CFE's investigators utilize two automated tools to compare the audit trail data provided by the TPH against the Exchange's records – CBOE's Market Replay and CFE Order History. Investigators utilize the Market Replay system to locate all trades or orders placed by a TPH and identify all trade details including: origin codes, executing firm, trade time, price, quantity, and order number. Investigators can search based on numerous data fields including: trade date and time, TPH, clearing firms, and CFE login. CFE's Order History application permits the following fields to be searched on from the Exchange's records: executing firm, CFE login, OEO ID, sub account, order ID, and trade times. The search results can be exported into a spreadsheet to allow for easier filtering and sorting of the data. This tool provides a broader range of search criteria than that which exists in Market Replay by allowing investigators to search a range of dates as opposed to a single trade date. Data from the Order History application is available on a T+1 basis, while Market Replay provides near-real time view of the data.

iv. Monitoring for Post-Execution Changes to CTI Codes and Account numbers; Monitoring Error Account Activity

Investigators monitor the usage of the CTI code,⁵⁰ account numbers and error accounts to detect any patterns suggesting possible misuse, errors, or violations of Exchange rules. To monitor and detect improper use of CTI codes, investigators review two months of complete

⁴⁹ As discussed in Section VI(A)(1), the following fields are required for all orders entered into CBOE Command: the product, executing firm, buy sell code, quantity, price, the time in force, account name, open close code, CBOE account type, and expiration date. For options, all orders must also include the strike price, whether the option is a put or call, and the expiration month. As of April 30, 2012, the Exchange began requiring TPHs to submit an OEO ID with every order or quote submitted.

⁵⁰ As discussed above, the CTI code is populated in the Exchange's audit trail through the CBOE account type.

audit trail data, including fill information, to ensure that the TPH is using the appropriate CBOE account type (which, in turn, should translate to the appropriate CTI code) and that it is being used consistently during the review period. Investigators can review any post-execution changes made to the CBOE account type using the CFE Allocations tool, which pulls data tables from OCC for sample trade dates and identifies any adjustments that were made to the origin where trades were cleared. Investigators also trace a sample of trades from the TPH's records through the Exchange's records, and then to the account statement to determine whether any post-clearing changes were made to the CBOE account type. To monitor and detect improper use of account numbers, investigators request account statements for sample trade dates to verify that the account numbers belong to the TPH as indicated. Investigators can also use the CFE Allocations application to identify instances where a post-execution change was made to the account number. Finally, investigators identify which of the TPH's accounts are error accounts and review trading activity in such accounts for the review period. Investigators also verify that the TPH has written supervisory procedures for error account activity.

v. Reviewing Adjustments and Transfer Activity

Investigators obtain and review all adjustments and transfers made by the TPH during a selected two-month period. While adjustments or transfers do not, in and of themselves, indicate a potential violation of Exchange rules, investigators may question any adjustments or transfers that appear excessive or unusual, and request documents, such as account statements, to verify any explanation provided by the TPH. Utilizing the CFE Adjustments application, investigators can identify any long or short quantity changes made at OCC and search for all adjustments that occurred on a single trade date or date range in a given year, or for all adjustments by a particular clearing firm. The CFE Transfers application allows investigators to identify instances where

positions have been transferred between clearing firms as well as internally between same beneficial owners. Investigators can search for all transfers that occurred on a single trade date or date range in a given year, or for all transfers by a particular clearing firm.

vi. Reviewing Compliance with OEO ID Requirements

With the availability of the OEO ID in the Exchange's audit trail, the exam program has been expanded to include a review of TPHs' compliance with the OEO ID requirements. As part of this review, investigators evaluate the TPH's procedures for issuing OEO IDs to ensure that they are unique at the clearing firm level and that the TPH can readily identify the natural person or ATS for which the OEO IDs are assigned. Investigators verify this information with the Exchange's records to ensure that the TPH is promptly notifying the Exchange of any changes to such information. To identify potential misuse of OEO IDs, Exchange staff identifies instances where an OEO ID is trading for several accounts or an OEO ID is trading for more than one session. To facilitate this review, staff utilizes the same surveillance tool used to conduct the Multiple User/Single Account review.

3. *Services Provided by NFA Related to the Audit Trail*

While NFA does not directly perform any services relating to the Exchange's audit trail enforcement program, an alert generated as part of its trade practice surveillance program is used by the Exchange to identify instances where multiple CTI codes are utilized by a single account on a given trade date. When the alert is generated, NFA contacts the TPH and requests specific information regarding the account in an effort to determine whether the appropriate CTI code was used. The Exchange staff is copied on all such communications. If the alert was triggered for any reason other than account set-up issues or trader input error, the matter is referred to the Exchange. As of December 1, 2012, NFA began logging all of the alerts generated on the basis

of multiple CTI code usage into a monthly report for the Exchange. Accordingly, the Exchange utilizes referrals made by NFA on the basis of this alert as a source for conducting audit trail investigations.

Exchange staff meets with NFA staff on a monthly basis to discuss that status of open investigations, any market maker incentive programs, and matters relating to surveillance conducted on behalf of the Exchange. This meeting also provides an opportunity to identify any potential audit trail issues that NFA uncovers in the course of its trade practice surveillance program, or potential trade practice issues that could result from the Exchange's audit trail enforcement program. In addition to these formal meetings, Exchange and NFA staffs maintain regular contact to discuss issues as they arise.

4. Disposition of Audit Trail Investigations and Examinations

Once an audit trail investigation or exam is completed, investigators document their findings in a case report. The case report is brought before of all CFER staff members for review at a Department meeting for management's approval. The Exchange refers to this meeting as a "draft meeting." If the decision is made to "file the matter without action"⁵¹ due to no apparent violations of CFE rules or Commission regulations, then the matter will be closed administratively at this meeting. If a determination is made to issue a Letter of Caution,⁵² or to recommend that the BCC issue a Statement of Charges, the matter proceeds to a "Pre-BCC" meeting where it is presented to senior staff of the Regulatory Services Division. The Pre-BCC meeting provides staff an opportunity to hone its presentation of a matter in preparation for the BCC meeting; CFER staff does not explicitly seek approval of its recommendation with respect

⁵¹ The Exchange uses the term "filed without action" to describe a matter that has been closed upon review and approval of CFE management.

⁵² The Exchange issues a Letter of Caution where a party violates a technical rule for the first time and it appears a letter is sufficient to prevent a recurrence. The letter serves as notice that another similar violation may result in a Statement of Charges.

to the disposition of a matter. All matters for which Exchange staff recommended a Letter of Caution or Statement of Charges will then advance to the BCC for review.

On January 23, 2013, the Exchange implemented a summary fine schedule for certain audit trail and recordkeeping violations, including: failure to include an OEO ID with an order or quote submitted to CBOE Command; improper use of OEO IDs; failure to comply with issuance, recordkeeping and reporting requirements related to OEO IDs; failure to identify correct account type in order; and failure to maintain front-end audit trail information. The schedule permits a Letter of Caution for the first offense for each of these violations, while subsequent violations within a rolling 12-month period will result in progressively larger fines, and ultimately, referral to the BCC for disciplinary action.⁵³ The fines established under this schedule range from \$2,500 to \$10,000.

5. Findings and Recommendations Regarding the Exchange's Audit Trail Enforcement Program

The Exchange has implemented an audit trail enforcement program that includes routine surveillance and annual exams to monitor TPHs' compliance with audit trail and recordkeeping requirements. The Division found that the Exchange's audit trail enforcement program adequately implements the following components: (1) monitoring for potential recordkeeping and audit trail violations; (2) reviewing paper order tickets for orders that cannot be entered immediately upon receipt; (3) reviewing sample front-end audit trail data; (4) monitoring for post-execution changes to trade information, including account numbers and CTI codes; (5) monitoring error account activity; (6) reviewing the accuracy of order entry data points; and (7) auditing, examining, and enforcing the proper assignment and usage of login IDs. In addition, the Division believes that the fines established under the summary fine schedule, which range

⁵³ Nonetheless, CFE Rule 714(d) permits the Exchange to proceed under its formal disciplinary rules "whenever it determines that any violation is intentional, egregious or otherwise not minor in nature."

from \$2,500 to \$10,000, are adequate to deter recidivist activity. Based on the foregoing, the Division has no recommendations in this area.

C. Audit Trail Examinations and Audit Trail Investigations Process

The Exchange tracks all audit trail investigations and exams using the Integrated Case Tracking System (“ICT”). The Exchange provided the Division logs that were generated from the ICT system listing all audit trail exams and investigations during the second target period. ICT logs list two types of “general investigations” pertaining to the audit trail enforcement program. One type of general investigation captures each surveillance activity conducted by the Exchange pursuant to its routine audit trail surveillance. Therefore, the routine surveillance activities conducted by the Exchange, such as the OEO review, are logged as a general investigation and are not attributed to any particular TPH. If, however, the routine surveillance reveals a potential violation that requires further investigation, then a separate general investigation listing the TPH under review will be opened. The second type of general investigation captures audit trail investigations pertaining to potential violative conduct identified by NFA referrals or routine audit trail surveillance. Finally, the examinations log lists all audit trail examinations.

Both logs include the date that the matter was opened and the date that it was closed in the ICT system. The date that a matter is opened varies depending on the matter type. According to the Exchange, audit trail exams are generally opened in the system the month that the exam was assigned to an investigator, prior to commencing the exam. Audit trail investigations pertaining to routine audit trail surveillance that are not attributed to any particular TPH (the first type of “general investigation” discussed above) are opened at the time the surveillance is assigned to an investigator, which is generally within the first two weeks of

following month for which the review covered. Finally, audit trail investigations that arise from NFA referrals or the results of routine audit trail surveillance are opened once Exchange staff determines that further investigation is warranted. For each matter, the close date represents the date on the entire regulatory process has been completed, including CFER's examination or investigatory work and the BCC's disciplinary action, if applicable, and the matter has been closed in the ICT system.

The logs also include the "last draft date" which is the date on which CFER management reviewed the case report during a draft meeting (which consists of all CFER regulation staff) and either approved the matter for closure or recommended a Letter of Caution or a Statement of Charges. Exchange staff explained to the Division that the date of the last draft meeting represents the date on which Exchange staff has substantively completed its examination and investigatory work, and that the recommendation regarding the disposition of the matter is final. Generally, any substantive changes made to the case report after this time would require that the matter be remanded to a subsequent draft meeting before proceeding to the Pre-BCC for review.⁵⁴ However, non-substantive changes to the case report that do not affect Exchange staff's recommendation regarding the disposition can be made without remanding the matter to a subsequent draft meeting.

One exception to this process is a matter for which Exchange staff recommends a Statement of Charges. The Exchange employs a "Wells" process for such matters. Prior to submitting an investigative report to the BCC for which staff finds a reasonable basis exists for finding a violation of Exchange rules, Exchange staff must notify the subject of the report and

⁵⁴ As discussed in section VI(B)(4), the Pre-BCC is a meeting of all of the departments within the Regulatory Services Division to review the cases that will be presented at the next BCC meeting. The Pre-BCC meeting provides staff an opportunity to hone its presentation of a matter in preparation for the BCC meeting; CFER staff does not explicitly seek approval of its recommendation with respect to the disposition of a matter.

allow the subject to submit a written statement to the BCC explaining why no disciplinary action should be taken.⁵⁵ As a practical matter, since this “Wells letter” is issued to the subject of the report ahead of the BCC meeting, Exchange staff may obtain additional investigative evidence that must be included in the case report before it is presented to the BCC. Therefore, the last draft date for these matters is not an accurate indication of when investigatory work was completed.

The Division is concerned that the open and closed dates maintained by the Exchange do not accurately reflect the actual time Exchange staff spent conducting examination or investigatory work on a matter. The open date does not appear to reflect the date that staff began working on the matter given that the Division found many instances in which investigators sent advisory letters initiating the exam prior to opening the exam in the ICT system. Furthermore, the Division notes that while the last draft meeting provides a general timeframe for when a matter was completed by CFER staff, this does not necessarily represent the date on which the report was approved as final since the possibility exists that subsequent changes could occur. The Exchange cannot identify a discrete “pens down” date on which all examination and investigatory work conducted by staff was completed, including any changes made to the case report, regardless of whether such changes affected the disposition of a matter. The Division believes that these logs should contain dates that accurately identify the beginning and end of each stage of a matter so that the timeliness of an investigation may be more easily ascertained by Exchange staff. Accordingly, the Division recommends the following:

- **All logs maintained by CFE contain accurate and meaningful dates, including the date that staff began its work and the date that staff completed all examination and investigatory work related to a matter.**

⁵⁵ CFE Rule 702(e).

D. Audit Trail Examinations and Audit Trail Investigations Completed During the Second Target Period

1. *Number and Sources of Investigations and Examinations Completed During the Second Target Period*

For purposes of this report, the Division used the date opened and last draft date listed in the logs provided by the Exchange to determine when an audit trail investigation or examination was initiated as well as completed by CFER staff. Accordingly, the Exchange opened 85 TPH audit trail examinations during the second target period, 25 of which were also completed during the second target period. Twenty of these 25 exams were filed without action, while five resulted in Letters of Caution issued to five separate TPHs. During the second target period, Exchange staff did not recommend a Statement of Charges for any audit trail exams.

During the second target period, the Exchange opened 12 audit trail investigations, five of which were also completed during that same time. Of the five completed investigations, three pertained to the Exchange's Multiple User/Single Account review for the months of July, August, and September 2011, and two arose from NFA referrals. Four of the completed audit trail investigations were filed without action; the Exchange issued a Statement of Charges for one audit trail investigation, which arose from a NFA referral for improper CTI code usage.⁵⁶ The Exchange's Multiple User/Single Account review conducted during the second target period did not identify any unusual or violative activity that resulted in disciplinary action.⁵⁷ All seven of the investigations that remained open after the second target period pertained to the Exchange's routine audit trail surveillance.

2. *Timeliness of Investigations and Examinations*

⁵⁶ See *infra* section VI(D)(3)(i) for a discussion of ICT # 99474.

⁵⁷ As CFE gains experience administering its audit trail enforcement program, the Division encourages the Exchange to evaluate the frequency with which actual and potential audit trail violations are being identified through routine surveillance reviews and calibrate the audit trail surveillance program accordingly to ensure its effectiveness.

To determine when an audit trail investigation or exam was initiated and completed by CFER staff, the Division used the date opened and last draft date⁵⁸ listed in the logs provided by the Exchange. Division staff examined the case files for the 25 TPH audit trail exams completed during the second target period to determine whether they were completed within a reasonable amount of time. The Division found that 13 of these 25 exams were completed within 90 days, while the remaining 12 exams took between 91 and 279 days to complete. Of these 12 exams, six took between 91 and 180 days to complete, five took between 181 and 270 days to complete, and one took 279 days to complete. The shortest and longest amount of time to complete an audit trail exam for which the TPH under review was actively trading⁵⁹ was 90 days and 279 days, respectively. Of the 60 audit trail exams that remained open at the end of the second target period, eighteen had been open for less than 90 days, 23 had been open between 90 and 180 days, ten had been open between 181 and 270 days, and nine had been open over 270 days.

The Division analyzed the 12 exams that took between 91 and 279 days to complete for mitigating factors, including the complexity of the exam, the volume of documents to be reviewed, whether the TPH actively traded on CFE during the review period, and whether unusual or violative activity was found. In four of the exams that took between 144 and 279 days to complete, the Division found that work was steadily ongoing, and certain mitigating factors existed, such as voluminous documents to be reviewed and the detection of potential audit trail violations that required analysis. Each of these four exams resulted in a Letter of

⁵⁸ As discussed in section VI(C), the last draft date is the date on which CFER management reviewed the case report during a draft meeting (which consists of all CFER regulation staff) and either approved the matter for closure or recommended a Letter of Caution or Statement of Charges.

⁵⁹ Fourteen of the audit trail exams conducted during the second target period involved TPHs that did not enter any orders, submit any quote or effect any trades on CFE during the period of time under review or the preceding five years. For these exams, investigators confirmed that the TPH did not receive any orders for CFE that could not be entered into CBOE Command and were kept in paper format. Should the TPH begin trading on CFE, an audit trail exam would be initiated within six months to verify the TPH's compliance with CFE's audit trail requirements.

Caution for the TPH under review. Nonetheless, the Division is concerned that these exams took an average of 207 days to complete. In an additional four exams that took between 127 and 227 days to complete, the Division noted a prolonged and unexplained period of time where it appeared that no examination work related to the matter was being conducted, and no mitigating factors existed to warrant an average of 176 days to complete these exams.

In conversations with Division staff, the Exchange has indicated that its goal for completing audit trail exams is four months. At the end of the second target period, 14 of the 25 completed exams were completed in four months. To help further its goal, the Exchange has implemented a summary fine schedule to streamline the disposition of audit trail investigations and examinations that would otherwise result in disciplinary action. Additionally, the Exchange seeks to enhance the efficiency of its exams by automating certain data comparison tasks and establishing a common format for receiving audit trail data from its TPHs. Finally, the Exchange believes that it can leverage the experience it has gained from administering the audit trail examination program to gain efficiency and improve the timeliness of the examination process.

The Division supports the Exchange's efforts toward attaining its goal with respect to completing audit trail exams within four months and also credits the Exchange for increasing its staffing levels in response to additional responsibilities undertaken by the Exchange with respect to the audit trail enforcement program. The Division also understands the challenge posed by the backlog of examinations that developed during the time that elapsed between the implementation of the audit trail examination program and the Department becoming fully staffed. Nonetheless, the Division believes that the four audit trail exams that took an average of 207 days to complete took longer than was warranted by the facts surrounding these exams. The Division

recommends that the Exchange continue focusing on reducing the time it takes to complete audit trail exams.

Division staff also reviewed the case files for the five audit trail investigations completed during the second target period to determine whether they were completed within a reasonable amount of time. Three of the five completed audit trail investigations pertained to the Multiple User/Single Account review for the months of July, August and September.⁶⁰ Since the Exchange first began conducting this review in September 2011, it reviewed trading for the month of September as well as for historical data during the months of July and August 2011. For each review, Exchange staff contacted the same three TPHs to verify that the CFE logins identified during the review were authorized to trade; an additional two TPHs were contacted as part of the September review. The investigations for the July and August review were completed in 45 days, while the investigation for the September review took 181 days to complete. In reviewing the case file provided by the Exchange, including correspondence between the Exchange staff and TPHs and their related parties, the Division did not find any mitigating circumstances to justify the delay in completing the September review.

The remaining two investigations, ICT # 98607 and 99474, which arose from NFA referrals for improper CTI code usage, remained open for 147 and 287 days, respectively.⁶¹ Since Exchange staff recommended the issuance of a Statement of Charges in ICT # 99474, the Division notes that 287 days is not an accurate indication of when investigatory work was completed because it does not reflect additional investigatory work resulting from the Wells process. Therefore, the Division looks to the date that the investigation was last presented at a BCC meeting to determine when Exchange staff completed its investigatory work for this matter.

⁶⁰ ICT #s 99636, 99637, 99716.

⁶¹ See infra section VI(D)(3)(i) for a discussion of ICT # 98607 and 99474.

Accordingly, the investigation appears to have remained open for 428 days before staff's final recommendation with respect to the disposition of this matter was last presented to the BCC. Although the Division did not identify any particular prolonged or unexplained periods of time that caused the delay, it appears that the untimeliness of these investigations can be attributed, in part, to Exchange staff's commingled efforts to investigate the matter as well as understand the structure of the underlying IT connectivity between the TPHs under investigation and the Exchange. The Division does not believe that the timeliness of Exchange staff's investigatory work should suffer in such a manner.

For all audit trail examinations and investigations arising from NFA referrals, the Division calculated the dates above based on the open date and draft date provided in the Exchange's logs. As discussed, the draft date does not, in all cases, represent the date on which the case report is approved as final by CFER management since changes may occur after the draft meeting. Moreover, since routine surveillance matters that do not reveal any unusual or violative activity are not presented at the draft meeting, and therefore do not contain a draft date, the Division used the date closed provided in the case reports for these matters. The Division found that the case reports for audit trail examinations do not include the date on which the report was approved by CFER staff and the signature of the approving senior CFER staff. The Division has previously stated that the date on which an investigation report is approved as final by senior compliance staff is necessary to determine whether responsibility for any delays in processing a matter rest with the compliance staff or the BCC.⁶² Accordingly, the Division recommends the following:

- **CFE should include in its case report the date on which the report was approved by senior CFER staff and the signature of the approving senior CFER staff.**

⁶² Rule Enforcement Review of ICE Futures U.S. (December 14, 2012).

- **CFE should continue to focus on reducing the time it takes to complete its annual audit trail examinations of TPHs.**
- **CFE should reduce the time it takes to complete audit trail investigations, including prompt review of the outputs generated by the automated systems used to conduct routine audit trail surveillance.**

3. Adequacy of Investigations and Examinations

Division staff reviewed the case reports and case files for all five audit trail investigations and 25 exams completed during the second target period. The Division typically found the quality and documentation of the investigations and examinations work to be thorough and complete. Where violative activity was identified in the course of a TPH audit trail exam or audit trail investigation, Exchange staff expanded the time period under review to determine how long the activity under review persisted, and whether it affected other areas of the Exchange's or NFA's surveillance programs. The Exchange's audit trail exams and investigations were thorough and well documented. Each case file included all pertinent underlying documents related to an examination, including correspondence between Exchange staff and the TPH. The case files also included the final version of the case report. With the exception of one investigation, the Division generally found that the Exchange's actions, and its decisions whether or not to pursue disciplinary action, were appropriate. Finally, the case reports for all completed investigations and examinations provided adequate explanations as to why Exchange staff recommended that the matter be filed without action or referred for further action.

i. Discussion of Completed Investigations

As discussed above, the Exchange completed five audit trail investigations during the second target period. Of the five completed investigations, three pertained to the Exchange's Multiple User/Single Account review for the months of July, August, and September 2011, and two arose from NFA referrals. Four of the completed audit trail investigations were filed without

action; the Exchange issued a Statement of Charges for one audit trail investigation, which arose from a NFA referral for improper CTI code usage.⁶³ All five audit trail investigations are discussed below.

Between September 30, 2011 and October 6, 2011, the Exchange opened three investigations related to the Multiple User/Single Account review for the months of July, August and September.⁶⁴ The investigators followed the procedures outlined in Section VI(B)(1) to conduct this surveillance. During the three-month period reviewed, investigators identified five accounts for which multiple CFE logins effected transactions.⁶⁵ The investigators contacted the TPHs to whom the CFE logins belonged and verified that the CFE logins were authorized to trade on behalf of the account. Accordingly, these investigations were filed without action on the basis that no violative activity was found.

The two audit trail investigations dealt with a set of related circumstances involving a TPH (“Subject TPH”). ICT # 98607 was opened to resolve inconsistencies between how CTI codes were defined by the Exchange and how the CTI and origin codes were translated from the CBOE account type by NFA. This issue was brought to the Exchange’s and NFA’s attention when numerous orders placed by the Subject TPH over an extended period of time contained the improper CTI code. To resolve the situation, the Exchange aligned its definition of the CTI codes with NFA’s definitions, and codified the requirements with respect to the CTI code in a Regulatory Circular issued on July 21, 2011. The matter was filed without action with respect to the Subject TPH.

ICT # 99474 arose from a NFA referral regarding the CTI code usage by accounts that cleared through the Subject TPH referred to in ICT # 98607. From July 22, 2011 through

⁶³ See *infra* for a discussion of ICT # 99474.

⁶⁴ ICT #s 99636, 99637, 99716

⁶⁵ Three of the five accounts identified were identified each month.

October 18, 2012, NFA and the Exchange identified many instances in which the Subject TPH submitted numerous orders with incorrect CTI codes to the Exchange on behalf of its clients, at least nine of whom were also CFE TPHs. To determine who was responsible for submitting improper CTI codes, Exchange staff considered whether the Subject TPH or its clients maintained control over the CBOE account type code. Upon extensive inquiry, the Exchange found the following: (1) for order flow coming through the Subject TPH proprietary front-end system, the Exchange found that Subject TPH was responsible for improper coding since it had control over the setup and modification of the CBOE account type; and (2) for order flow coming through a mechanism other than the Subject TPH's proprietary front-end system, the clients were responsible for the improper coding since they maintained control over the setup and modification of the CBOE account type. Accordingly, Exchange staff recommended that the BCC issue a Statement of Charges to the Subject TPH and recommended that the investigation with respect to the Subject TPH's clients be filed without action.⁶⁶ Exchange staff noted in the case report that its basis for recommending a Statement of Charges was "[d]ue to the length of time taken between when CFER and NFA brought these issues to [Subject TPH's] attention and the time the situation was remedied..." The BCC imposed a \$30,000 fine and a censure to the Subject TPH.

Exchange staff's findings are predicated on the basis that the clients trading through the Subject TPH's front-end system did not have control over the setup of the CBOE account type, and therefore, were not responsible for submitting incorrect CTI codes. However, the Division did not find any evidence in the case file to suggest that Exchange staff considered whether the

⁶⁶ The investigation with respect to the Subject TPH's clients was separated into a distinct audit trail investigation, ICT # 102291, which remained open at the end of second target period.

clients trading in their own capacity as CFE TPHs⁶⁷ had an obligation independent of the Subject TPH to submit correct CTI codes in accordance with Exchange rules. In addition, while these clients received advisory letters notifying them of the investigation, it does not appear that Exchange staff engaged in a direct inquiry of these clients to determine their role in submitting the incorrect CTI codes. Rather, the case file appears to indicate that Exchange staff would query these clients regarding their CTI code usage during the annual audit trail exam process. Finally, Exchange staff did not address the improper CTI code usage by the clients that used a mechanism other than the Subject TPH's front-end system to access CFE. Since these clients had control over the CBOE account type, and were therefore responsible for submitting incorrect CTI codes, the Division believes that Exchange staff should have issued a Letter of Caution to these clients for submitting improper CTI codes. Accordingly, the Division recommends the following:

- **CFE should promptly take appropriate disciplinary action when it identifies violations of its audit trail or recordkeeping requirements by persons subject to CFE's rules. At a minimum, CFE should remind persons subject to its rules of their continuing compliance obligations even when services are received from third parties.**

ii. Discussion of Completed TPH Audit Trail Examinations

As discussed, the Exchange completed 25 of the 85 audit trail examinations opened during the second target period. Exchange staff issued Letters of Caution to five separate TPHs for audit trail violations. Two TPHs received Letters of Caution for failing to maintain audit trail data, two for incorrect account origin code, and one for incorrect account origin code and failing to notify CFE of change in responsible trader. A total of 20 audit trail examinations were filed without action: 14 of the examinations were filed without action on the basis that the TPH under

⁶⁷ In this situation, the clients themselves were CFE TPHs and accessed the Exchange via the Subject TPH's front-end system.

review did not enter any orders, submit any quote or effect any trades on CFE during the period of time under review or the preceding five years: while six of the audit trail exams were filed without action due to no apparent violations of Exchange or Commission rules. All five of the completed audit trail examinations that resulted in Letters of Caution are discussed below.

A second set of related matters, ICT # 99240 and 99242, were routine audit trail exams of two separate TPHs that were accessing the Exchange through the same ISV. One of the TPHs conducted customer trading and clearing for CFE products, while the other TPH conducted proprietary trading. During the review of audit trail records from sample trade dates, investigators found that in both instances the audit trail data sent to the Exchange was correct, but that the TPH was maintaining the incorrect CTI code in its own records.⁶⁸ Further inquiry revealed that both TPHs were accessing the Exchange through the same ISV, and that the CTI code issue related to how the ISV was populating the audit trail record. The ISV corrected the issue by adding a new column to its audit trail records to retain the CBOE account type data. The investigator noted that the incorrect audit trail data did not impact the Exchange's surveillance for trading ahead or front running since the incorrect data resided with the TPHs and not the Exchange. In both instances, Exchange staff recommended that a Letter of Caution be issued to the TPH for violating Exchange rules 403(a) and (c) for maintaining audit trail data which had incorrect CTI code information in the order messages and sample trade dates.

ICT # 99241 was a routine audit trail exam of a TPH that conducted proprietary trading. During the review of audit trail records from sample trade dates, the investigator found that the

⁶⁸ TPHs audit trail records contained orders with CTI 1 and the origin code "customer," which represents transactions for the TPH's own account or an account the TPH controls or has a financial interest. However, the TPH submitted CBOE account type "C" which translates into CTI 4 and origin code "customer," representing non-TPH customer transactions.

TPH was submitting the incorrect CBOE account type.⁶⁹ Upon expanding the time period under review, the investigator found that the TPH had been submitting the incorrect CBOE account type code since it became a TPH in December 2009 due to its misunderstanding of the translation of the CBOE account type to CTI and origin codes. The investigator noted that submitting the incorrect CBOE account type did not give the TPH any apparent advantages or cause the TPH to avoid surveillance for trading ahead or front running since the TPH was solely conducting proprietary trading. The exam also revealed that the TPH changed its responsible trader without notifying the Exchange in the manner required by Exchange rules. Finally, the exam revealed one instance where audit trail records showed duplicate orders due to the manner in which the ISV retrieved the data. Exchange staff recommended that a Letter of Caution be issued to the TPH for violating Exchange rule 403(a) for failing to send account order entry information to the Exchange and for failing to promptly notify the Exchange of the change to the TPH's responsible trader. Exchange staff recommended that the violation for Exchange rules 403(a) and (c) for providing audit trail data which had duplicate order messages be filed without action "because the data was stored within the guidelines of the rules but was pulled incorrectly due to a third party error."

ICT #99678 was a routine audit trail exam of a TPH that conducted proprietary trading. The exam revealed that the TPH had been submitting the incorrect CBOE account type code during the sample trade dates reviewed.⁷⁰ Upon expanding the time period under review, the investigator noted that the firm had been submitting the incorrect CBOE account type since it

⁶⁹ TPHs audit trail records contained orders with CTI 2, which represents orders for a proprietary account of a clearing or non-clearing member. However, the orders sent to the Exchange were submitted with CBOE account type "V" which translates to CTI 1, representing transactions for the TPH's own account or an account the TPH controls or has a financial interest.

⁷⁰The TPH submitted CBOE account type "M" which translates into CTI 2 origin code "market maker," representing market maker transactions. However, since the TPH was a customer of a clearing firm and was trading proprietary funds, all orders should have been submitted with CBOE account type "O" which represents CTI 2 origin code "customer."

became a TPH in September 2010. The investigator also noted that submitting the incorrect CBOE account type did not give the TPH any apparent advantages or cause the TPH to avoid surveillance for trading ahead or front running since the TPH was solely conducting proprietary trading. Exchange staff recommended that a Letter of Caution be issued to the TPH for violating Exchange rule 403 for sending orders with incorrect account origin code information to the Exchange.

ICT # 101389 was a routine audit trail exam of a TPH that conducted proprietary trading. The exam revealed that during the two-month period under review, the TPH's orders were marked with the incorrect CBOE account type code on multiple occasions.⁷¹ Although the TPH corrected this error upon discovering the error, there were subsequent instances where an incorrect origin code was used for trades executed via its backup trading platform. The investigator noted that submitting the incorrect CBOE account type did not give the TPH any apparent financial benefit, such as excess rebates. Exchange staff recommended that a Letter of Caution be issued to the TPH for violating Exchange rule 403 for sending orders with incorrect account origin code information to the Exchange.

The Division has no recommendations regarding completed TPH audit trail examinations completed during the second target period.

⁷¹ The TPH used CBOE account type "C" which translates to CTI 4 origin code "customer", which represents non-TPH customer transactions. However, since the TPH was trading proprietary funds, all orders should have been submitted with CBOE account type "O" which represents CTI 2 origin code "customer."