

**RULE ENFORCEMENT REVIEW  
OF  
ONECHICAGO**



**Division of Market Oversight**

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# **RULE ENFORCEMENT REVIEW OF ONECHICAGO**

## **I. INTRODUCTION**

The Division of Market Oversight (“Division”) has completed a rule enforcement review of the market surveillance, audit trail, trade practice surveillance, disciplinary, and dispute resolution programs of OneChicago (“OneChicago” or “Exchange”) for compliance with related core principles under Section 5(d) of the Commodity Exchange Act (“Act”) and Part 38 of the Commission’s regulations. The review covers the period of August 1, 2003 to December 31, 2004 (“target period”).<sup>1</sup>

The Division evaluated the Exchange’s compliance with Core Principles 2 and 12, which relate to surveillance, enforcement, and disciplinary procedures used by a contract market to protect market participants from abusive trading practices; Core Principles 4 and 5, which relate to the prevention of manipulation and price distortion, and the enforcement of speculative position limit and position accountability rules; and Core Principles 10 and 17, which relate to the maintenance of an audit trail that can be used in the identification and prosecution of customer and market abuses, and the maintenance of trade-related records. The Division also reviewed the Exchange’s compliance with Core

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<sup>1</sup> The target period for this review was extended beyond the typical 12-month review period in order to examine a sufficient number of investigatory matters. Rule enforcement reviews prepared by the Division are intended to present an analysis of an exchange's overall compliance capabilities for the period under review. Such reviews deal only with programs directly addressed in the review and do not assess all programs. The Division's analyses, conclusions, and recommendations are based, in large part, upon the Division's evaluation of a sample of investigation and disciplinary case files, and other exchange documents. The evaluation process, in some instances, identifies specific deficiencies in particular exchange investigations or methods but is not designed to uncover all instances in which an exchange does not address effectively 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.

Principle 13, which relates to the establishment and operation of an alternative dispute resolution program.<sup>2</sup>

For purposes of the review, Division staff interviewed staff and officials from OneChicago and the Chicago Mercantile Exchange (“CME”).<sup>3</sup> The CME performs certain regulatory services on behalf of OneChicago, including trade practice and market surveillance, pursuant to a Regulatory Services Agreement entered into between the two parties on April 2, 2002.<sup>4</sup> The Division also reviewed numerous documents used by CME staff in carrying out the Exchange’s routine oversight responsibilities. These documents included, among other things, the following:

- computer reports generated by CME’s automated surveillance systems and other documents used for OneChicago market surveillance and trade practice surveillance;
- files and records concerning contract expirations and speculative limit enforcement;
- files and records concerning market surveillance and trade practice inquiries and investigations closed during the target period;
- OneChicago trade practice and market surveillance procedures manuals, logs, and guidelines;
- provisions of the Regulatory Services Agreement which describe the scope of the self-regulatory services performed for the Exchange by CME; and

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<sup>2</sup> Appendix B to Part 38 of the Commission’s regulations provides guidance concerning the core principles with which a designated contract market must comply to maintain its designation. In addition, Appendix B provides acceptable practices for several of the core principles. Although the acceptable practices establish non-exclusive safe harbors, they do not establish a mandatory means of compliance with the core principles. Appendix B provides acceptable practices for Core Principles 2, 4, 5, 10, 13, and 17. However, acceptable practices are not set forth for Core Principle 12. In promulgating Part 38, the Commission reserved the authority to adopt acceptable practices for Core Principle 12 at a later date.

<sup>3</sup> A copy of the interview transcript can be found in Appendix 1. Cites to the transcript are herein referenced as “Transcript, p. \_.”

<sup>4</sup> Pursuant to OneChicago Rule 702, the Exchange’s Division of Market Regulation may consist of staff provided from a third party with which the Exchange has entered into a contractual agreement for such purposes.

- minutes of all meetings of the OneChicago Board of Directors held during the target period.

The Division provided OneChicago an opportunity to review and comment on a draft of this report on June 15, 2005. On June 22, 2005, Division staff conducted an exit conference with Exchange and CME officials to discuss the report's findings.

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

### **A. Market Surveillance Program**

#### **Findings**

- The Exchange maintains an adequate market surveillance program. CME monitors OneChicago markets' price relationships, volume, open interest, and market news on a daily basis. CME also reviews clearing member and large trader positions in conjunction with contract expirations. In addition, exchange of futures for physicals transactions are routinely reviewed for compliance with the Exchange's requirements.
- Expiration Summary Files are prepared for each month's expiring contracts. The files contain documentation of last trading day surveillance activities, including clearing member and reportable positions, and price, volume and open interest data.
- There were no problematic expirations during the target period, with all contracts expiring in an orderly fashion.

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

### **B. Audit Trail Program**

#### **Findings**

- The Exchange maintains an adequate audit trail program. A complete electronic record of all entries into the OneChicago System's trading host is maintained. Time of order entry, trade matching and modifications to orders are automatically captured by the system, allowing CME to efficiently and effectively reconstruct trading.
- CME has integrated OneChicago's audit trail data into its automated surveillance systems in order to identify potential trading violations and provide evidence of any rule violations.

- CME has adequate procedures for the safe storage of OneChicago audit trail data. Data are backed up daily and stored at both the CME and at an off-site location.

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

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

#### **Findings**

- The Exchange maintains an adequate trade practice surveillance program. CME reviews computerized exception reports and other automated surveillance reports daily, some of which have been designed specifically for security futures products. CME also has developed an automated system to monitor for insider trading.
- CME closed 20 inquiries during the target period, including 16 insider trading inquiries. Fifteen of the insider trading inquiries were generated from referrals by equity and equity option exchanges that trade the underlying security or option on the security. The remaining insider trading inquiry was internally generated.
- All of the inquiries closed during the target period were thorough, well documented, and completed in a timely manner.

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

### **D. Disciplinary Program**

#### **Findings**

- The Exchange has the authority to investigate possible rule violations, prosecute cases, and discipline members and market participants.
- Exchange rules provide that respondents shall have the right to counsel, and have sufficient opportunity to present their defense, call witnesses, and offer evidence.
- Since there were no matters referred for disciplinary action during the target period, the Division was unable to evaluate the adequacy of the Exchange's disciplinary program at this time.

## **E. Dispute Resolution Program**

### **Findings**

- Exchange rules provide fair and equitable procedures for the resolution of customer and member disputes.
- Customers have the opportunity to have their claims heard by majority non-member panels. With respect to both customer and member arbitrations, all parties receive adequate notice of the claims against them, have the right to counsel, and have the opportunity to present their claims, defenses, and counterclaims.
- Since there were no requests for arbitration filed during the target period, the Division was unable to evaluate the adequacy of the Exchange's dispute resolution program.

## **III. OVERVIEW OF ONECHICAGO**

### **A. Joint Venture to List Security Futures Products**

OneChicago was approved by the Commission as a designated contract market on June 12, 2002, and began trading security futures products (“SFPs”) on November 8, 2002. OneChicago is a joint venture of CME, the Chicago Board Options Exchange (“CBOE”) and the Chicago Board of Trade. Members of the joint venture partners are automatically OneChicago members and can trade through existing memberships and accounts.<sup>5</sup> OneChicago clearing members must be clearing members of either CME or the Options Clearing Corporation (“OCC”). Clearing firms that are members of CME, but not the OCC, clear OneChicago products through the CME clearinghouse. Clearing firms that are members of OCC, but not CME, clear OneChicago products through OCC. OneChicago clearing firms who are clearing members of both CME and OCC may choose either clearinghouse.

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<sup>5</sup> At the end of the target period, OneChicago had approximately 125 clearing member firms and 7,500 individual members.

At the close of the target period, OneChicago's SFPs included 120 single stock futures, one Exchange Traded Fund futures contract, and seven narrow based Dow Jones MicroSector Index futures contracts. The products are traded electronically on the OneChicago System, which uses a modified version of the CBOEdirect match engine. The OneChicago System can be accessed through either CBOEdirect or CME's GLOBEX platform. During the target period, the Exchange's trading volume totaled 2,732,718 contracts, for a monthly average volume of 160,748 contracts. Volume ranged from a low of 51,821 contracts in February 2004 to a high of 375,463 contracts in March 2004. Approximately two-thirds of OneChicago's volume is proprietary business and one-third is customer business.<sup>6</sup> Block trades accounted for almost 51 percent of the Exchange's volume during the target period.

OneChicago is an "affiliate" member of the Intermarket Surveillance Group ("ISG"), a membership organization created in 1983 by the major U.S. securities exchanges to share information regarding securities-related products. The "affiliate" category of ISG membership was created in 1990 to allow participation by futures exchanges and non-U.S. exchanges. ISG participation requires an agreement to share information concerning related products for the purpose of conducting routine surveillance, and to otherwise coordinate investigative efforts, including those involving potential inter-market violations, such as frontrunning and insider trading.<sup>7</sup>

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<sup>6</sup> Transcript, p. 25.

<sup>7</sup> Section 2(a)(1)(D)(i)(VIII) of the Act and Section 6(h)(3)(I) of the Securities Exchange Act of 1934 ("Exchange Act") require that exchanges trading SFPs have procedures in place for coordinated surveillance with other markets on which SFPs trade, any market on which any security underlying the SFP is traded, and other markets on which any related security trades. The coordinated surveillance is facilitated by the ISG. In 2002, the Commission and the Securities and Exchange Commission ("SEC") jointly issued interpretive guidance regarding coordinated surveillance and the role of the ISG in such surveillance. *See* 67 FR 36740, 36750-36752 (May 24, 2002).

As noted above, OneChicago has contracted with CME to provide regulatory services for OneChicago. These services, which are provided by CME's Market Regulation Department, include trade practice and market surveillance, and the investigation and prosecution of disciplinary matters. CME also performs auditing and financial surveillance activities for OneChicago.

**B. Market Regulation Staff**

CME's Market Regulation Department consists of 57 staff members who are responsible for detecting, investigating, and prosecuting rule violations, in addition to conducting market surveillance. The department is headed by a very experienced and knowledgeable management team. The Market Regulation management team, which includes the Director of Market Regulation, a Director who also serves as Compliance Counsel, six Associate Directors, and five Managers, reports to the Managing Director of Regulatory Affairs.<sup>8</sup> Other Market Regulation staff includes daily investigators, general investigators, data analysts, and compliance systems staff.<sup>9</sup>

Trade practice surveillance for OneChicago is primarily conducted by CME's 11 daily investigators. Two daily investigators and one systems person were added when CME assumed OneChicago's regulatory responsibilities. Three individuals concentrate their surveillance activities on OneChicago markets, but also monitor CME products.

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<sup>8</sup> The Managing Director of Regulatory Affairs has served in this position for four years. Prior to this appointment, his CME experience, which totals 27 years, included 11 years as Senior Vice President Regulatory Affairs, two years as Vice President of Market Regulation, three years as Vice President of Market Surveillance, and six years as a Market Regulation Director. The Director of Market Regulation has 24 years of CME compliance experience and the six Associate Directors have combined CME compliance experience totaling over 60 years (one Associate Director with 20 years of experience, one Associate Director with 16 years of experience, two Associate Directors with 14 years of experience, one Associate Director with 9 years of experience, and one Associate Director with 3 years of experience).

<sup>9</sup> CME investigators are further classified as "senior investigator," "experienced investigator," or "investigator," depending upon their experience and assigned level of responsibilities.

The daily investigators review various analysis reports, exception reports, and databases to identify potential trading violations. When potential violations are identified or when a customer, member or other complaint or referral is received, daily investigators will open an “inquiry.” If the inquiry reveals that a rule violation may have occurred, the daily investigator opens a formal investigation, collects the additional data, and refers the matter to a general investigator for further investigation.<sup>10</sup> During the target period, there were no inquiries that rose to the level of a formal investigation.

CME’s market surveillance staff is led by two Associate Directors and includes two managers, and five analysts. The staff has extensive industry and CME compliance/surveillance experience ranging from four years to more than 26 years. Market surveillance activities are performed by the senior market surveillance analyst responsible for monitoring CME equity index products. That analyst has 18 years experience at CME. Other CME analysts are available to assist with OneChicago market surveillance activities if increases in volume require additional staff.<sup>11</sup>

#### **IV. MARKET SURVEILLANCE**

##### **Core Principle 4 – Monitoring of Trading:**

**The board of trade shall monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.**

##### **Core Principle 5 – Position Limitations or Accountability:**

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<sup>10</sup> CME has nine general investigators, who conduct the latter stages of investigations and shepherd potential disciplinary matters through the committee process. They interview witnesses, gather and analyze documents, prepare written investigation reports, and present evidence to the appropriate committee.

<sup>11</sup> In addition to CME’s trade practice and market surveillance staffs, six systems staff support Market Regulation’s data and systems needs, and work with CME’s information technology group. These staff members maintain databases and produce customized programming, as necessary, to generate specific OneChicago trade data reports.

**To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary and appropriate.**

Pursuant to the acceptable practices set forth in Appendix B to Part 38 of the Commission's regulations, an acceptable market surveillance program should regularly collect and evaluate market data to determine whether markets are responding to the forces of supply and demand. An exchange also should have routine access to the positions and trading of its market participants. To diminish potential problems that may arise from excessively large speculative positions, an exchange may need to establish speculative limits for some commodities. Such limits may provide for hedge exemptions and set limits differently by markets, delivery months, or time periods. Spot month limits should be adopted for markets based on commodities having more limited deliverable supplies or where necessary to minimize a market's susceptibility to manipulation or price distortion.

Position limits are not necessary for markets where the threat of excessive speculation or manipulation is very low. For some contracts, such as financial instruments, an exchange may provide for position accountability in lieu of position limits. An exchange which trades several products with a large number of traders should have an automated large trader reporting system that is used daily to enforce compliance with position limit rules.

**A. Prices, Volume, Open Interest and Market News**

In order to detect potential market manipulation and price distortions, and to ensure the orderly liquidation of expiring contracts, CME conducts daily monitoring of prices, volume, open interest, clearing member and large trader positions, and market

news for all OneChicago contracts. OneChicago products have been fully integrated into CME's market surveillance program so that market surveillance of OneChicago and CME contracts is conducted in an identical manner.

Price data and market news are collected from several sources, including Bloomberg, Reuters, and the Internet. Exchange staff review daily price changes in order to identify anomalous prices, and examine historical price and spread relationships to determine the various influences on OneChicago markets. Staff also monitors the spread relationships between each contract and its underlying stock, and between different months in each contract.

Volume and open interest also are monitored daily. CME reviews the previous trading day's volume and open interest for each contract via the Daily Bulletin. The Daily Bulletin contains volume and open interest statistics and the daily high, low, and settlement prices for each contract. Staff also reviews the Position Adjustment Report to monitor any adjustments to open interest. The Position Adjustment Report indicates an adjustment made by a firm to its open interest.<sup>12</sup>

#### **B. Large Trader Reporting System**

Clearing firms must report daily the position of all accounts at or above OneChicago's reportable level of 200 contracts. CME and CBT clearing members, non-clearing FCMs, and foreign brokers submit reportable positions to CME, which transmits these data to the Securities Industry Automation Corporation ("SIAC"). OCC clearing members and other non-OCC member firms clearing through an OCC member submit reportable positions for customer accounts directly to SIAC. SIAC consolidates all of the

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<sup>12</sup> Adjustments are necessary when a clearing member incorrectly reports its open position to the clearinghouse. A copy of a Position Adjustment Report can be found in Appendix 2.

large trader data and transmits a data file to the Commission and CME.<sup>13</sup> In addition, firms must file a CFTC Form 102 with the Exchange, as well as the Commission, when an account first becomes reportable. The Form 102 identifies account owners and provides account control and contact information.

Large trader data are maintained in the CME's Reportable Position System ("RPS"), which includes all large trader data. RPS data is used to enforce compliance with rules regarding reportable accounts, open interest reporting, aggregation of accounts, as well as for risk management purposes, speculative limits, and any other aspect of large trader reporting. All reports used to review large trader activity are available on-line. Users access data through a series of computer reports and on-line screen applications that analyze large trader activity according to predetermined sorts. RPS provides users with the capability to sort and analyze data based on individually selected criteria, such as by contract, contract month, clearing member, or account number.

Three RPS reports used routinely are the Watch/Account Report, Rank by Size Report, and the Book Report. These reports facilitate the monitoring of large trader positions for concentrations of ownership or concerted trading. The Watch/Account Report allows staff to monitor the aggregate positions of all participants in a particular "watch/account," and to detect potential concentrations of positions as they develop. A "watch/account" is a set of accounts that are grouped together based on specific criteria, such as accounts under common ownership or control, or that exhibit similar trading patterns. Each "watch/account" is assigned a specific "watch number." Positions carried for each account under the same watch number can be separately extracted.

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<sup>13</sup> OCC transmits reportable position data directly to the Commission and CME for individual market makers.

The Rank by Size Report allows staff to sort and rank reportable positions in a variety of ways. For example, an analyst may choose to view the five watch/accounts with the largest reportable positions or the clearing members carrying the five largest reportable positions. Finally, the Book Report indicates each reportable account's current position, the previous day's position, and the change between the two.<sup>14</sup>

### **C. Contract Expirations**

As OneChicago contracts approach expiration, CME focuses its attention on large trader positions, position concentrations among clearing members, and volume and open interest distribution among market participants. Staff also closely monitors underlying equity prices, futures prices, spread relationships, and any unusual market circumstances that may raise the potential for a liquidation problem.

In addition, CME monitors scale-down spot month position limits as expiration nears. Pursuant to OneChicago Rules 414 and 902(f), and Commission Regulation 41.25, market participants are required to scale-down their SFP positions during the spot month either to 13,500 or 22,500 contracts long or short, depending on the daily trading volume in the underlying security, within five trading days of expiration.<sup>15</sup> The scale-down spot month limits were adopted in order to prevent any trader from carrying a position which, by virtue of its sheer size, could adversely affect prices or otherwise have a negative impact on the orderly liquidation of a contract. There were no instances of positions

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<sup>14</sup> A copy of the Watch/Account, Rank by Size, and Book Reports can be found in Appendix 3.

<sup>15</sup> OneChicago Rule 414 is the Exchange's general position limit rule and establishes the procedures for hedge exemption requests. OneChicago Rule 902(f) states that position limits for SFPs held during the last five trading days of an expiring contract month shall follow the speculative position limit rules set forth in Commission Regulation 41.25. Regulation 41.25 provides that the position limit may increase from 13,500 to 22,500 contracts in those SFPs in which the average daily trading volume in the underlying security exceeds 20 million shares and in which there are more than 40 million shares of the underlying security outstanding.

approaching the scale-down limits or any problematic contract expirations during the target period.<sup>16</sup>

CME staff routinely compiles Expiration Summary Files (“ESFs”) for each expiring SFP. The ESFs typically contain documentation of last trading day surveillance activities, including a Daily Bulletin reflecting price, volume, and open interest information, and large trader and clearing member position data.

#### **D. Exchange of Futures for Physicals**

OneChicago Rule 416 authorizes and governs exchange of futures for physical (“EFP”) transactions. EFPs must involve only two parties such that the seller of the futures is the buyer of the cash (*i.e.*, the underlying security), and the seller of the cash is the buyer of the futures. Separate parties are required on each side of the EFP with different beneficial ownership and separate trading control. EFPs may be executed at prices that are mutually agreed upon by the two parties to the transaction. In addition, the futures and the underlying security must be directly correlated and transfer of ownership of the security is required to take place in a reasonable time after the futures side is executed.

The Exchange’s reporting procedures require that both parties to the transaction transmit, via e-mail, a completed EFP Transaction Report within a reasonable period of time to the OneChicago Operations Management Help Desk (“Help Desk”).<sup>17</sup> The Help

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<sup>16</sup> In addition, there were no hedge exemption requests during the target period. If a position were to approach or exceed the scale-down limit, Market Regulation would contact the account holder to remind them of their position and provide them with information regarding the hedge exemption application process.

<sup>17</sup> Market Regulation considers an EFP Transaction Report submitted within one hour of an executed transaction to be submitted within a reasonable time period. Copies of OneChicago’s EFP Guidelines and Reporting Procedures and an EFP Transaction Report form are attached as Appendices 4 and 5.

Desk compares the details of the parties' reports and if the reports match, the EFP transaction is posted on the OneChicago System.

EFPs are routinely monitored for compliance with Rule 416. The Final EFP Report, which for each EFP shows the contract, contract month, quantity, clearing firm, price, account number, submission time, and execution time, is reviewed to identify EFPs for further examination.<sup>18</sup> EFPs are typically chosen for review based upon various criteria including, but not limited to, unusual size, the same clearing firm on both sides, or any apparent relationship between the accounts for which the EFP was executed.

During the target period, CME staff closed four EFP reviews which examined six EFPs. Five of the six transactions involved large size EFPs, ranging from 1,000 to 2,500 contracts. Division staff examined the four closed EFP reviews and found that they were well documented and completed in a timely manner. Each file included, among other things, pertinent cash-side documentation, account statements, and relevant correspondence. The files also contained summary memoranda describing the investigator's analysis and conclusion, and more detailed memoranda describing pertinent communications and steps in the investigation. The summary memoranda contained appropriate analysis to conclude that the futures and the underlying security were correlated, that separate parties were on each side of the transaction, and that a transfer of the cash-side securities occurred.

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

The Division found that the Exchange maintains an adequate market surveillance program. CME has successfully integrated the monitoring of OneChicago products into

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<sup>18</sup> A copy a Final EFP Report can be found in Appendix 6.

its existing market surveillance program. CME routinely monitors prices, volume, open interest, and market news to augment analyses of market activity and contract expirations. OneChicago large trader data are included in CME's Reportable Position System or RPS, which staff uses to monitor reportable accounts for concentrations of ownership and/or concerted trading. Staff can sort and analyze data in the RPS based on individually selected criteria.

Expiration Summary Files are routinely prepared for each month's expiring contract. The files typically include a Daily Bulletin reflecting price, volume and open interest summary information for the last day of trading, and spreadsheets showing reportable positions and clearing member positions on the last trading day. There were no problematic expirations during the target period.

Finally, CME staff reviews selected EFPs to ensure that they comply with OneChicago's EFP requirements. The Division reviewed the four EFP investigations closed during the target period and found that they were thorough, well documented and completed in a timely manner. The investigation files included, among other things, documentation of the cash-side transactions, account statements, and pertinent correspondence.

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

## V. AUDIT TRAIL

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

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

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

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

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

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

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

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

**A. Order Flow and Recordkeeping**

As noted earlier, OneChicago uses a modified version of the CBOEdirect match engine for its electronic trading platform, the OneChicago System. Members may grant customers access to enter orders directly into the OneChicago System either through the use of a clearing member or third party order routing system via the GLOBEX or CBOEdirect's Application Program Interface.<sup>19</sup> Several front-end trading platforms are available for access to CBOEdirect and GLOBEX. These include FCM provided systems, proprietary systems, independent software vendor systems, as well as CBOEdirect workstations and GLOBEX Trader workstations.

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<sup>19</sup> OneChicago Rule 101 defines an individual or entity granted such access into the OneChicago System by a clearing member as an "Access Person." Under OneChicago Rule 403, clearing members are responsible for all orders entered by any individual or entity that it has permitted to act as an Access Person, and for compliance by such Access Person with the Exchange's order entry requirements.

In order to enter OneChicago orders into CBOEdirect or GLOBEX, a user must enter a user ID and password. Customers also may telephone or electronically transmit orders to a member for entry into the OneChicago System. If an order cannot immediately be entered, the member must immediately prepare and timestamp a written order ticket that includes the time of receipt, account designation, date, and other required information.<sup>20</sup> The order then must be entered into the OneChicago System when it becomes executable.

The OneChicago System will not accept orders that do not include all of the information required under Exchange rules. OneChicago Rule 403(a) requires that orders entered into system must indicate whether the order is a buy or sell, and include the order type, contract, contract month, price, quantity, account type, and account designation. Trades are matched pursuant to the matching algorithm by price/time priority and order type, and reports of fills are transmitted back through CBOEdirect or GLOBEX, depending on which system the orders were entered. The trade is then sent for post trade processing and reported over the CBOE Financial Network, a ticker system for OneChicago trading.

The OneChicago System automatically records, among other things, the time of order entry, trade matching, and any order modifications. These electronically-recorded data provide an unalterable audit trail and are incorporated into CME's surveillance reports, which are used to detect possible trading abuses.

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<sup>20</sup> Most orders are entered directly into the OneChicago System, in which case, no order ticket would be prepared. However, if staff is reviewing a trade practice matter, written order tickets, if any, would be reviewed. In addition, in the course of conducting financial audits for those firms for which CME is the designated self-regulatory organization, CME will review a sample of OneChicago order tickets if the firm's business includes SFPs and the firm has prepared any written order tickets.

## **B. Safe Storage Capability**

OneChicago trade and order data are stored and maintained in online databases and backed-up on CME's mainframe system. The mainframe system is protected from unauthorized alteration and accidental erasure. Trade data also is copied monthly and sent to a private company for secure off-site storage. CME has recently opened a remote back-up facility in suburban Chicago, at which a redundant database of OneChicago trade data is maintained. When the final phase of this remote site installation is completed in 2006, the Exchange will have the capability to run all surveillance programs from this location in the event of an emergency or disaster. As required under Commission Regulation 1.31, OneChicago records will be maintained for a minimum of five years.

CBOE provides backup and disaster recovery services for the OneChicago System that include real-time data storage, connections to multiple electrical grids, an electrical power generator designed to provide power when a grid is down, and substantially real-time data backup to a geographically distinct location.

## **C. Conclusions and Recommendations**

The Exchange maintains an adequate audit trail program. OneChicago's rules and procedures provide for the recording and safe storage of trade data in a manner that enables the CME to use the information to identify trading violations and to provide evidence of any rule violations. The Exchange maintains a complete electronic record of all entries into the OneChicago System trading host, allowing CME staff to efficiently and effectively reconstruct trading. In this regard, the time of order entry, trade

matching, and any modifications to an order are automatically captured. Finally, CME has adequate procedures in place for the safe storage of OneChicago audit trail data.

Data are backed-up daily and stored at both the CME and an off-site facility.

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

## **VI. TRADE PRACTICE SURVEILLANCE PROGRAM**

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

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

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

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

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

An acceptable program should have systems that maintain all data reflecting the details of each transaction executed on the contract market. In this regard, the program should include routine electronic analysis of these data to detect potential trading violations. The program also should provide for appropriate and thorough investigation of all potential trading violations brought to the contract market's attention, including

member and Commission referrals and customer complaints. In addition, the program should have the authority to discipline, suspend, or terminate the activities of members or market participants pursuant to clear and fair standards.<sup>21</sup>

#### **A. Automated Surveillance**

CME staff conduct trade practice surveillance of OneChicago markets in much the same manner as surveillance is conducted for CME markets. However, some surveillance reports have been designed specifically for security futures products and CME has developed the Insider Trading Alert System (“INTAS”) to monitor for instances of possible insider trading. In addition, CME staff uses MercQuote, CME’s in-house quotation system that includes OneChicago price quotes and volume, to monitor for unusual price changes, abnormal price relationships, and volume spikes on a real-time basis. Other automated tools used for the surveillance and analysis of OneChicago trading include CME’s Virtual Detection System (“VDS”), Regulatory Trade Browser (“RTB”), and RegWeb. These systems, along with INTAS, are described below.

##### **1. Insider Trading Alert System**

INTAS, which uses a real time price feed from Reuters that updates price and volume information for each stock underlying a OneChicago security future, generates price alerts that are e-mailed to a daily investigator when stock price movements exceed specified alert levels. The e-mail alert also is recorded in a database and populates an exception screen. The exception screen summarizes the statistical data for the alert, and provides hyperlinks to relevant documents and news stories.

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<sup>21</sup> That aspect of Core Principle 2 that relates to the disciplining of members who violate Exchange rules is discussed below in Section VII. This section of the report addresses the Exchange’s program for monitoring its markets for possible trading abuses and the investigation of any identified abuses.

Under CME's insider trading surveillance procedures, an investigator reviews the news reports relating to the underlying stock, as well as economic data and other information that may have impacted the stock price.<sup>22</sup> The investigator then reviews futures transaction and position data for a period of approximately one to four weeks prior to the alert or news event for any unusual trading activity that might indicate that someone traded on insider information. For example, an account that typically holds a small position in a particular security futures contract that puts on an unusually large position a few days prior to the release of news or a research report regarding the underlying security likely would be assigned for an inquiry. With one exception, CME's review of INTAS price alerts during the target period did not reveal activity that warranted the opening of an insider trading inquiry because the price movements were not associated with corporate news events or unusual trading activity. However, as described in more detail below, CME opened one insider trading inquiry based on an INTAS alert.

Pursuant to agreements among ISG members, if a determination is made to open an insider trading inquiry, CME would notify and coordinate its investigative efforts with those exchanges trading the underlying stock. Conversely, OneChicago is notified when a market trading an underlying security or option on a security opens an insider trading investigation involving a security for which OneChicago trades the futures contract. CME will then open an inquiry and review the trading in the related futures contract. CME opened 15 such inquiries during the target period.

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<sup>22</sup> CME's insider trading surveillance procedures are attached as Appendix 7.

## **2. Virtual Detection System**

VDS displays exception and informational reports for OneChicago trading based on cleared trade and quotation data. VDS exception reports, which are reviewed daily, include the Trading Ahead of Customer Orders Report, which compares the trading activity of the personal accounts of a terminal operator entering customer orders into the OneChicago System to customer orders that the terminal operator entered during a market rally or a break; the Direct/Indirect Trading Opposite Customer Orders Reports, which identify terminal operators who enter customer orders and trade opposite those customer orders directly or by using accommodators; and the Direct/Indirect Wash Trades Report, which searches for two types of wash trades- one wherein a single account is the buyer and seller in the same transaction, and the other wherein a third party acts as an accommodator with no profit or loss on the transaction.

VDS informational reports include the Trade Percentages Report, which allows staff to compare percentages of trading among users to detect possible prearrangement, and the Daily and Month-End Profit and Loss Reports, which display the profit and loss for each member's account.

## **3. Regulatory Trade Browser**

The RTB system is a flexible ad hoc desktop query tool used by CME to further analyze potential trading violations identified in VDS exception reports, and to create customized reports in furtherance of investigations.<sup>23</sup> RTB permits users to query any field of trade data or any combination of fields to create reports that can be displayed in multiple formats and downloaded into an Excel spreadsheet for further analysis. Trading

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<sup>23</sup> Currently, RTB includes all OneChicago trades since the November 2002 launch. At a minimum, RTB will always include at least two years of OneChicago trade data, with older data being archived.

activity on RTB can be queried and sorted by any criteria on the trade record for a specified period of time, such as by account number, trader and clearing firm. For example, if VDS identifies a potential instance of wash trading, an investigator can query RTB to isolate all instances of a particular firm or account trading opposite itself over a selected time frame to determine if there is a pattern of wash trading.

#### **4. RegWeb**

RegWeb is a system populated with detailed cleared trade and audit trail data, including matched, unmatched, modified and cancelled orders. RegWeb is used to create trader profiles of OneChicago participants. These profiles identify the products, trading volume, and other statistics for market participants, and assist in identifying anomalous trading activity. For example, a statistical profile can be created to show the average transaction size for a particular account in one or all SFPs over a specified time period. Such information allows staff to determine whether a trade or series of trades may be suspicious and merit further examination.

RegWeb also provides staff with access to the Frontrunning Report and the Pre-Execution Discussion Report. The Frontrunning Report identifies [ redacted ] within a certain period of time after the large order is executed. CME also monitors for inter-market frontrunning, which involves a party using the futures market to frontrun a large order in the underlying stock. CME monitors for this type of activity by comparing large transactions on OneChicago that are

executed within [ redacted ] of a large block trade in the underlying stock on the same side of the market.<sup>24</sup>

The Pre-Execution Discussion Report shows instances of possible violations of OneChicago's pre-execution discussion policy. The policy requires that when market participants engage in pre-execution discussions, one side must be exposed to the market for four seconds before the other party to the discussion can take the opposite side of the order.<sup>25</sup> The Pre-Execution Discussion Report displays transactions in which four seconds or less elapsed between order entry and execution. Staff can sort the data to display the exceptions for a single firm, all firms, a selected account, or a selected user identifier.

#### **B. Surveillance of Block Trades**

OneChicago Rule 417 and the Exchange's block trading policy permit eligible contract participants, as that term is defined by Section 1(a)(12) of the Act, to engage in block trades in a minimum size of 500 contracts.<sup>26</sup> Most block trades occur during quarterly expirations when market participants roll their positions into the next expiring contract.<sup>27</sup> OneChicago requires that the seller call the OneChicago Help Desk "without delay" after a block trade is negotiated and report the terms of the trade, including the contract, contact month, price, quantity, and opposite party information. Most block

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<sup>24</sup> CME receives a daily feed of block trades in each underlying market from SIAC to compare trading in OneChicago contracts to block trades in the underlying security.

<sup>25</sup> OneChicago's Pre-Execution Discussions Policy is attached as Appendix 8.

<sup>26</sup> OneChicago's Block Trade Policy is attached as Appendix 9.

<sup>27</sup> Transcript, p. 61. The following is a list of the number of block trades for each month during the target period: August 2003 (0), September 2003 (98), October 2003 (0), November 2003 (5), December 2003 (141), January 2004 (28), February 2004 (4), March 2004 (128), April 2004 (4), May 2004 (19), June 2004 (68), July 2004 (54), August 2004 (18), September 2004 (102), October 2004 (20), November 2004 (30), and December 2004 (28).

trades are reported within two to three minutes.<sup>28</sup> The Help Desk inputs both sides of the trade to the OneChicago System, and the trade terms are then posted on OneChicago's price reporting system.

OneChicago also requires that each party prepare an order ticket that contains the contract, contract month, quantity, price, time of execution, counterparty, and account identification. Additionally, after a block trade has been reported to the Help Desk, both the buyer and seller must submit a Block Trade Reporting Form to the Help Desk via facsimile or e-mail as soon as practicable. The form requires the same information recorded on the order ticket and additional information for clearing and bookkeeping purposes.<sup>29</sup> CME is notified either by telephone or facsimile of all block trades at the end of the trading day, and receives a Block Trade Report, which lists the details of all block trades, from the OneChicago Help desk the following day.

CME reviews the daily Block Trade Report to ensure that block trades satisfy the minimum size requirement and are reported in a timely manner. CME also reviews the report to determine whether the same account may be on both sides of the transaction, which may be indicative of a wash trade, and whether the agreed upon price is reasonable considering factors such as the size and time of the trade. A price which appears to be out-of-line for the time that the trade was reported can be indicative of a trade that was not timely reported. CME's daily review of the Block Trade Report did not identify any

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<sup>28</sup> Transcript, p. 27.

<sup>29</sup> A copy of the Block Trade Reporting Form is attached as Appendix 10. Upon request, any party to a block trade must provide evidence, including order tickets, that the subject trade satisfies the requirements of OneChicago Rule 417 and the Exchange's block trading policy.

block trades requiring further examination. However, CME opened two inquiries based on a member complaint involving the possible frontrunning of two block trades.<sup>30</sup>

### **C. Adequacy of Inquiries**

CME closed 20 OneChicago inquiries during the target period. All but two of the inquiries were opened during the target period. Sixteen of the inquiries resulted from ISG participant referrals regarding suspicious trading of underlying stocks for which OneChicago trades the single stock futures contracts. Fifteen of these referrals involved potential insider trading and one involved suspicious trading on the close.<sup>31</sup> Of the remaining four inquiries, two were generated from the above-mentioned complaint regarding block trades and two were internally generated, one involving wash trading and the other involving insider trading.<sup>32</sup>

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<sup>30</sup> OneChicago Rule 417 prohibits any person with knowledge of a pending OneChicago block trade from entering orders in the specific contract or any related OneChicago product until the trade has been reported and published. Similarly, no person who has knowledge of a block trade pending on an ISG participant exchange for an underlying whose derivative is traded on OneChicago may place offsetting orders for the related future on OneChicago until the block trade is reported and published by the subject exchange. The member complaint involved allegations that on two separate occasions the member's bids and offers were hit just prior to the reporting of large blocks in the underlying stocks, resulting in the member receiving disadvantageous fill prices. CME found that in both instances, the party who took the opposite side of the member's trades was not a party to the securities block trade in question, and that the member's fills were the result of normal market activity. Inquiry Nos. 03-20031 and 03-20035.

<sup>31</sup> With respect to the trading on the close referral, NYSE advised OneChicago that it had identified 11 days of unusual trading activity on the close for a particular underlying over a 3 week time period. Market Regulation reviewed trading in the respective single stock futures contract for the same period, but found no unusual or suspicious activity. The inquiry was closed with no further action. Inquiry No. 04-20054.

<sup>32</sup> With respect to the wash trading inquiry, a routine analysis of trade practice reports and cleared trade data revealed several instances in which a market maker's proprietary account appeared as both the buyer and seller in several transactions in various contracts. CME staff interviewed a representative of the firm, and found that the trades resulted from a software problem with the firm's Automated Trading System. The system was allowing legs of the firm's proprietary spread orders to be traded against the firm's outright bids and offers that were being maintained in its capacity as a market maker. CME concluded that the trades were inadvertent and closed the inquiry. The firm modified its software to prevent recurrence. Inquiry No. 03-20027.

*See* pp. 28-29 for a detailed discussion of Inquiry No. 03-20043, the insider trading inquiry that was initiated from an INTAS alert.

The Division reviewed all 20 inquiries, and found that they were thorough, well documented, and completed in a timely manner. All of the inquiries were closed with no further action, with the exception of one insider trading inquiry, discussed below, that was [ redacted ]. In addition to pertinent trade data and reports, all of the files included a General Information Form which is prepared by an investigator, and approved by his or her manager, when opening an inquiry. The form includes information such as the file number, date the inquiry was opened, case subject(s) and a brief description of why the matter was opened. All of the inquiry files also included File Closing Forms. These forms include the subject(s), investigator, open and close dates, a brief description of the review and analysis conducted, and the final disposition.

With respect to the insider trading referrals, File Closing Forms and documents demonstrated that investigators analyzed large trader positions, transactional data and trading volume to determine whether there was any suspicious trading or any unusually large positions in the futures contract. In all but one instance in which an investigator found that a party held a large position during the relevant time period, the investigator found that the position was established at least four months prior to the release of the market news. Consequently, those inquiries were closed with no further action.

The one exception involved trading surrounding the announcement of a takeover bid for [ redacted ] by [ redacted ]. CME opened its inquiry five days after the public announcement, and subsequently received a referral from the International Securities Exchange (“ISE”), an ISG-participant exchange, that ISE was reviewing options trading

on [redacted] stock prior to the takeover announcement.<sup>33</sup> CME obtained copies of “chronologies” that had been prepared by both companies and their respective investment advisors at the request of the NYSE, who was reviewing the trading in the underlying stocks. An insider trading chronology provides a chronological history of the corporate news event, including descriptions of meetings (date, purpose, and who attended), e-mails, and letters associated with the event from inception to the news announcement. For example, [redacted] chronology notes specific meetings such as when [redacted] first considered the proposed takeover and when the proposed takeover was discussed with [redacted] board, dates that advisors and legal counsel were retained, and dates of meetings between the advisors and legal counsel.

CME’s file also included several other documents that had been requested from the relevant parties by the NYSE and ISE. These documents included, among other things, board minutes, lists of employees involved in or aware of the proposed takeover; copies of confidentiality agreements executed by [redacted] directors and employees who worked on or advised on the project; and letters in response to NYSE requests to [redacted], [redacted], and their advisors regarding individuals who had knowledge of the proposed takeover prior to the public announcement.

In addition, CME examined whether there was any unusual trading activity in [redacted] and/or [redacted] during the three week period prior to the public announcement or the two days following the announcement, the same time period reviewed by ISE. CME’s review identified one account that had nearly doubled its large long position in [redacted] futures three weeks prior to the announcement, and liquidated

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<sup>33</sup> Inquiry No. 03-20043.

a portion of the position in the days following the announcement for a profit of \$630,846. CME also found that the same account liquidated a large long position in [redacted] futures three weeks prior to the announcement, avoiding a potential loss of \$783,520 based on the price of [redacted] following the announcement.

Although CME's review of the corporate chronologies and other information did not reveal any connections that linked the account to any [redacted] or [redacted] insiders, given the timing of the relevant trading in the account, CME [redacted].

#### **D. Conclusion and Recommendations**

The Division found that OneChicago maintains an adequate trade practice surveillance program. CME's Market Regulation Department reviews computerized exception reports and informational reports on a daily basis to monitor for potential trading abuses. Staff also has the capability to conduct ad-hoc queries of trading data, and to create trader profiles for market participants. In addition, CME developed its Insider Trading Alert System to monitor for potential insider trading violations. The system sends alerts to investigators when price movements in an underlying stock exceed certain parameters. CME also reviews block trades on a daily basis to ensure that they were transacted in conformance with OneChicago's block trade rule and policy.

During the target period, CME closed 20 inquiries, 16 of which involved potential insider trading. Fifteen of the insider trading inquiries were opened based on referrals from other ISG exchanges and one insider trading inquiry was internally generated. The Division found that all of the inquiries were thorough, well documented and completed in a timely manner. The results of the internally generated insider trading inquiry were [redacted].

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

## **VII. DISCIPLINARY PROGRAM**

### **Core Principle 2 - Compliance With Rules:**

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

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

#### **A. Disciplinary Committees**

##### **1. Probable Cause Committee**

OneChicago's Probable Cause Committee's ("PCC") primary function is to determine whether there is a reasonable basis to charge a rule violation. The committee has the authority to compel the subject of any investigation ("Subject" or Respondent") to appear before it, to testify, and to produce all relevant records.<sup>34</sup>

The PCC consists of a variable number of persons appointed by the board of directors.<sup>35</sup> Any panel of the PCC that determines whether a Notice of Charges ("Notice") should be issued must consist of five members representing a chairperson, clearing members or Exchange members, and two non-members. Panel decisions are made by majority vote. All PCC members must agree that they will protect the

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<sup>34</sup> OneChicago Rule 704(a).

<sup>35</sup> Currently, 16 individuals serve on the PCC, including a chairperson, 11 OneChicago members, and four non-members.

confidentiality of any information obtained through their PCC service. In addition, PCC members are prohibited from *ex parte* communications.<sup>36</sup>

## **2. Business Conduct Committee**

The Business Conduct Committee is responsible for enforcing rules relating to the trading practices, sales practices, and trading ethics of Clearing members and Exchange members. This includes rules pertaining to manipulation, attempted manipulation, corners, and attempted corners; conduct detrimental to the good name of the Exchange; conduct affecting customers or the public; and compliance with the rules of the Exchange. The BCC may act on its own initiative or upon referral from the Exchange, including CME and the PCC.<sup>37</sup>

The BCC consists of a variable number of persons appointed by the board of directors.<sup>38</sup> BCC panels considering a matter must consist of a chair and five members, three representing clearing members or Exchange members, and two representing non-members. Panel decisions are made by majority vote. However, if a novel or significant issue is presented, the BCC chairperson may choose to have the matter decided by the entire BCC, rather than by a panel. All BCC members must agree to protect the confidentiality of any information obtained in their official capacity. In addition, *ex parte* communications are prohibited.<sup>39</sup>

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<sup>36</sup> OneChicago Rule 704(b) and (c).

<sup>37</sup> OneChicago Rule 703(a).

<sup>38</sup> Currently, 16 individuals serve on the BCC, including a chairman, 12 OneChicago members, and three non-members .

<sup>39</sup> OneChicago Rule 703(b) and (c).

## **B. Disciplinary Procedures**

CME investigates possible rule violations and provides the results of those investigations to OneChicago's President. If a matter is investigated as an inquiry and a determination is made to close the matter with no further action, a File Closing Form describing CME's review and analysis is prepared and copied to the President. If an inquiry discloses evidence of a potential rule violation, then a formal investigation is opened and an investigation report ("IR") is prepared. As stated earlier, no inquiries were converted to investigations during the target period.

The PCC reviews all IRs submitted by CME, and determines whether a reasonable basis exists for issuing charges alleging violation of an Exchange rule. It may direct that charges be filed, that non-disciplinary regulatory action be taken, or that the matter be closed.<sup>40</sup> All PCC determinations, including the reasons therefore, must be in writing. If the committee elects to file charges, CME prepares a Notice of Charges ("Notice") on its behalf and serves it upon the Subject(s).

A Notice must indicate the OneChicago rule allegedly violated, describe the conduct in question, and advise the Respondent of its opportunity to submit a written answer within ten days. Answers must admit or deny each charge made in the Notice. If a Respondent is unable to obtain information necessary to admit or deny a charge, the charge is deemed denied. If a Respondent fails to file an answer, all charges are deemed admitted. Respondents must be given 15 days prior written notice of the time and place

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<sup>40</sup> The President may request that the BCC reconsider any PCC determination. OneChicago Rule 705(d).

of hearing. They also must be advised of the right to be present at any hearing and to be represented by counsel.<sup>41</sup>

At any time prior to or after being served with a Notice, a Respondent may, without admitting or denying guilt, submit to the BCC a written offer of settlement consenting to specified sanctions (“Offer”). A Respondent also may submit a written statement in support of his or her Offer. If CME will not recommend that the Respondent’s Offer be accepted, the Respondent may appear before the BCC in person. Likewise, if the BCC rejects an Offer that CME supports, the Respondent may make an oral statement to the BCC concerning why it should reverse its decision. BCC final decisions with respect to offers of settlement may not be appealed.<sup>42</sup>

Prior to a hearing, the Respondent and CME must furnish to the BCC, and to each other, copies of all documentary evidence to be used at the hearing and a list of witnesses. Although formal rules of evidence are not applicable, both the Respondent and CME may testify, present evidence, call witnesses, and cross-examine witnesses. A record of the hearing must be made, but need not be transcribed unless a transcript is requested by the Respondent, the Exchange, or the Commission. After a hearing, the BCC must issue a written report of its findings that summarizes the Notice, answer, and evidence presented, and states its findings regarding each charge, specific violations of Exchange rules, sanctions, and their effective dates.<sup>43</sup>

A Respondent found guilty of a rule violation may appeal the BCC’s decision to the Board of Directors unless the monetary sanction imposed is for \$10,000 or less. At

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<sup>41</sup> OneChicago Rule 705(e).

<sup>42</sup> OneChicago Rule 705(g).

<sup>43</sup> OneChicago Rule 706.

the Board's discretion, appeals may be heard by the whole Board or a committee of the Board. The Board or Board committee's decision is final.<sup>44</sup>

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

The Exchange has the authority to investigate possible rule violations, prosecute cases, and discipline members or market participants who are found guilty. Respondents receive adequate notice of the claims against them, and have sufficient opportunity to present their defenses, call witnesses, and offer evidence. Respondents also are afforded the right to counsel, may enter into settlement negotiations, and may appeal unfavorable decisions to the Board of Directors. Disciplinary panels include non-members of the Exchange, and all panel members are required to maintain the confidentiality of any information obtained through the disciplinary process. Since there were no matters referred for disciplinary action by CME to OneChicago during the target period, the Division was unable to evaluate the adequacy of the Exchange's disciplinary program at this time.

## **VIII. DISPUTE RESOLUTION PROGRAM**

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

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

Pursuant to acceptable practices set forth in Appendix B to Part 38, an exchange is required to provide customer dispute resolution mechanisms that are fair, equitable, and available on a voluntary basis. Customers should have the opportunity to have their claims heard and decided by an objective and impartial decision maker. In addition, each

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<sup>44</sup> OneChicago Rule 708(a), (c), and (e).

party should have the right to counsel, adequate notice of claims presented against him or her, and an opportunity to be heard on all claims, defenses, and counterclaims. The process should provide for a prompt hearing, as well as prompt, written, final settlement awards that are not subject to appeal within the exchange. The parties also should be notified of the fees and costs that may be assessed. Finally, if an exchange provides procedures for the resolution of member-to-member disputes (not involving customers), the procedures for resolving such disputes must be independent of, and not interfere with, the resolution of customers' claims or grievances.

**A. Customer Arbitration**

Pursuant to OneChicago Rule 801(a), OneChicago customers are afforded voluntary dispute resolution in accordance with the National Futures Association's ("NFA") Code of Arbitration ("Code"). The NFA Code is incorporated into the Exchange's rules by reference. Matters subject to arbitration include any dispute, claim, or controversy between a customer and a Clearing member or Exchange member, in connection with or related to Exchange business. Under the NFA Code, arbitration is permitted only within two years of the act or transaction that is the subject of controversy.<sup>45</sup>

Arbitration proceedings are initiated when the party desiring to submit a matter to arbitration ("claimant") files an arbitration claim with the NFA. In the alternative, potential claimants may notify NFA, orally or in writing, of their intent to arbitrate, and thereby toll the statute of limitations.<sup>46</sup> Where an aggregate claim amount does not exceed \$50,000, NFA appoints one arbitrator, but a party may demand three arbitrators

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<sup>45</sup> NFA Code of Arbitration, ¶ 6035.

<sup>46</sup> NFA Code of Arbitration ¶ 6041.1.

for claims between \$25,000 and \$50,000. If the aggregate claim exceeds \$50,000, NFA appoints three arbitrators. All arbitrators are appointed by the Secretary of NFA, and consist of individuals who are NFA members or connected with members. However, customers may request that the panel chairperson and at least one other arbitrator, or the sole arbitrator in a single-person panel, not be NFA members or connected with members.<sup>47</sup>

Arbitration proceedings are held at a time and place determined by NFA. Each party has the right to be represented by counsel.<sup>48</sup> Each party also has the right to present its claims, defenses, counterclaims, evidence, and witnesses. Prior to hearing, parties may formally request relevant documents and information from other parties. Parties may examine witnesses appearing at hearing. The arbitrators, at the request of any party, may direct the appearance of any member, or any person employed by any member, who is not a party to the arbitration. They may also direct the production of any records in the possession or control of such persons.<sup>49</sup>

Arbitration panels must render a decision within 30 days from the date the record is closed. The decision must be signed, in writing, and reflect the panel's majority. The panel may award damages sought, and may assess interest, costs, and fees. Awards are final and there is no right of appeal, except that a party may, within 20 days, request a modification because of evident material miscalculation of figures, scope, or

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<sup>47</sup> NFA must promptly notify the parties in writing of the name, business affiliation, and classification (member or non-member) of each arbitrator, and parties have the right to file specific written objections to particular arbitrators. Arbitrators have a continuing obligation to notify NFA of any circumstances likely to affect their impartiality, including bias, financial interest in the outcome of the arbitration, or any past or present relationship with the parties or their representatives. In addition, parties have a similar obligation to notify NFA of any such relationships with an arbitrator. The parties must be notified of any such notifications. NFA alone determines whether an arbitrator should be disqualified.

<sup>48</sup> NFA Code of Arbitration ¶ 6047.

<sup>49</sup> *See generally*, NFA Code of Arbitration ¶ 6048 and ¶ 6053 for pre-hearing and hearing procedures.

imperfections in form. Awards may be entered as a judgment in any court of competent jurisdiction.<sup>50</sup>

Any award granted to a claimant against a member or an employee of a member must be paid within 30 days after the member or employee is served with the award. Failure to satisfy an award is a violation of OneChicago rules and grounds disciplinary action under Exchange rules.<sup>51</sup> In addition, the President of NFA may, on 30 days written notice, summarily suspend a Member or Associate Member, or employee thereof, for failure to comply with an award within 30 days of service.

There were no customer arbitrations at OneChicago during the target period.

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

OneChicago's member-to-member arbitration procedures are substantively similar to those for customer arbitration. Member-to-member arbitrations are governed by OneChicago Rule 801(b), which again incorporates the NFA Code by reference. Unlike customer arbitration, Clearing member and Exchange member arbitration is mandatory for any dispute, claim or controversy arising in connection with, or otherwise related to, Exchange business.<sup>52</sup> Arbitration panels for member-to-member disputes consist only of NFA members or persons connected with members.

Where the aggregate claim amount does not exceed \$100,000, NFA appoints one arbitrator, but a party may request a three-member panel if the amount is between \$50,000 and \$100,000. If the aggregate claim amount exceeds \$100,000, then three

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<sup>50</sup> See generally, NFA Code of Arbitration ¶ 6059 for awards and modifications.

<sup>51</sup> OneChicago Rule 802.

<sup>52</sup> OneChicago Rule 801(b).

arbitrators are appointed.<sup>53</sup> NFA must notify the parties of each arbitrator's name, business affiliations, and other relevant information.

As with customer arbitrations, there is a two-year statute of limitations for member arbitrations. The statute of limitation is tolled once a Notice of Intent to Arbitrate is filed.<sup>54</sup> Parties in member-to-member arbitrations have the right to representation by counsel.<sup>55</sup> Each party also has the right to present its claims, defenses, counterclaims, evidence, and witnesses. Arbitration panels must render their decisions within 30 days after the record is closed. As with customer arbitrations, awards are final, and there is no right of appeal except for specific circumstances. Awards must be honored within 30 days of service, or further disciplinary action may be taken.

There were no member arbitrations at OneChicago during the target period.

### **C. Conclusion and Recommendations**

The Division found that the Exchange's rules provide fair and equitable procedures for the resolution of customer and member disputes. Customers have the opportunity to have their claims heard by majority non-member panels. With respect to both customer and member arbitrations, all parties have the right to counsel. Parties also receive adequate notice of the claims against them, and have an opportunity to present their claims, defenses, and counterclaims. Arbitration panels must issue their decisions within 30 days, and parties must comply with any awards within 30 days of service. All decisions are final, except for a limited right of appeal in special circumstances. Since there were no requests for arbitration filed during the target period, the Division was

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<sup>53</sup> NFA Code of Arbitration ¶ 6523.1.

<sup>54</sup> NFA Code of Arbitration ¶ 6535.1.

<sup>55</sup> NFA Code of Arbitration ¶ 6541.

unable to evaluate the adequacy of the Exchange's dispute resolution program at this time.