



U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5110
Facsimile: (202) 418-5522

TO: Vincent McGonagle
Director, Division of Market Oversight

FROM: Miguel A. Castillo, CPA, CRMA
Assistant Inspector General for Audits

DATE: August 5, 2015

SUBJECT: Performance Audit of the Division of Market Oversight's Rule Enforcement Reviews

The Commodity Futures Trading Commission (CFTC, Commission or Agency) Office of Inspector General (OIG) contracted with Castro & Company, LLC (Castro & Co) to conduct a Performance Audit of CFTC's Rule Enforcement Reviews (RERs).

What We Learned

Castro & Company, LLC ("Castro & Co") identified the following issues based on procedures performed during the examination of CFTC's Market Compliance Branch. A summary of these areas for improvement are identified below with a further explanation included within the Notification of Findings and Recommendations section of this report.

The audit noted the following issues:

Finding No. 1: The Division of Market Oversight (DMO) is not conducting rule enforcement reviews of all core principles. When 16 of 23 core principles are not reviewed, it may hamper DMO's ability to meet CFTC's strategic goal of promoting market integrity and transparency;

Finding No. 2: Procedures for selecting designated contract markets (DCM) for a RER needs to be improved. When 9 of 20 DCMs are not reviewed, there is a risk of noncompliance with the Commodity Exchange Act;

Finding No. 3: Follow-up procedures on concerns and recommendations made in prior RER reports needs to be enhanced. Without robust follow-up, there is the risk that DCMs will not address reported concerns and recommendations timely; and

Finding No. 4: Inadequate staffing leads to lengthy RER completion time. When completion time averages 591 days due to inadequate staffing, DMO risks that it will not effectively fulfill its business objective of market oversight.

Recommendations

Castro & Company recommends the DMO Market Compliance Branch:

1. Implement operating procedures that ensure DCMs comply with all Core Principles. A standardized checklist will enable the review team to document exceptions.
2. Enhance documentation of its procedures for selecting DCMs to be reviewed.
3. Strengthen procedures for following up promptly on all concerns and recommendations issued to a DCM.
4. Take steps to reduce average time between rule enforcement reviews.

Management Comments

Management generally concurred with the findings and recommendations. In reference to recommendation 1, management stated that RERs are not optimal for all core principles and that certain core principles are better addressed outside the RER process. In addition, for certain core principles it is more effective and efficient for other CFTC divisions to lead oversight. While acknowledging additional resources allows more principles to be evaluated, in the interim it will develop an annual process to evaluate and recommend additional core principles for review.

In reference to recommendation 2, management agrees that RER selection can be better documented but disagrees that Compliance has not established a policy and criteria for DCM selection. The DMO will draft a recommendation for desired frequency of RERs for each tier of DCM and consider trading volume changes in selections.

In regards to recommendation 3, management will enhance its transmittal letters to include a timeline for corrective action and follow-up.

For recommendation 4, management appreciates the auditor's willingness to elevate inadequate staffing that limits the ability to review DCMs. While citing staffing limitations and a focus on rule-making as the major causes of extended RER cycle times, staff will continue to promote market integrity and customer protection under these circumstances.

Management did not provide action completion dates for the four recommendations. Their comments in its entirety can be found in [Appendix B](#).

Evaluation of Management Comments

While acknowledging staffing constraints, Castro and Co reiterated the need to enhance procedures for monitoring RERs and following-up with DCMs. Their evaluation of each finding and recommendation can be found on pages 4, 8, 10 and 14, respectively. Castro and Co also suggested that OIG follow-up on management actions, and we intend to do so.

With regard to staffing constraints, we would stress that Castro and Co. recommended that CFTC “determine whether more staff is needed to timely complete RERs or establish the frequency for conducting RERs with existing staff so as to provide timely results to DCMs.” We note with approval that recent CFTC investments in data analytical tools may provide an opportunity to migrate the RER process from a FTE intensive checklist approach to a data-driven alert-based approach. Based on DCM risk profiles and anomaly alerts, subject matter experts across CFTC could collaborate on selections, review procedures, and timeframes for completion.

Since management did not provide action completion dates, the Office of the Inspector General will assess the status of actions in the next semiannual reporting period. If management implements corrective actions prior to six months after the report date, please submit a formal closeout request to us so that we may close the recommendation(s). The request should be accompanied by evidence of completion of corrective actions. Please email a signed PDF copy of all responses and closeout requests to lwilliams@cftc.gov. Consistent with our responsibility under the Inspector General Act, we will provide copies of our report to appropriate Congressional committees. The report will be published on the OIG webpage and a synopsis will be presented in the October 2015 Semiannual Report to Congress. If you have any questions, please contact me at (202) 418-5084.

Objective, Scope, & Methodology

The objective of the audit was to review DMO Market Compliance Section’s performance in conducting RERs finalized during Fiscal Years 2011 through 2014. Castro & Co reviewed DMO responsibility for conducting RERs under the Commodity Exchange Act and the Dodd-Frank Act; evaluated frequency of the RERs; length of time to complete RERs; and remediation of CFTC identified RER findings and recommendations for improving the operations at DCMs. Further the audit team examined the current size of the Market Compliance Branch staff responsible for conducting RERs and commented on their ability to deliver a timely and quality product that achieves the CFTC’s stated goals for this oversight function of DCMs -- in light of expanded CFTC jurisdiction over the swaps markets.

In order to meet the objectives of the performance audit, Castro & Co:

- Obtained a business overview and understanding of internal controls associated with Market Compliance Branch responsibilities;
- Documented practices and procedures for conducting RERs of DCMs;
- Assessed the effectiveness in the design of relevant internal controls;
- Reviewed RERs conducted during the audit period and assessed implementation and operating effectiveness of existing internal controls;

- Reviewed documentation to support the timing of the RERs and amount of time to conduct a RER and assessed the reasonableness of the timing aspect of the RERs; and
- Reviewed documentation on number of individuals and experience levels of team members conducting RERs.

To ensure that the audit was conducted in accordance with Generally Accepted Government Auditing Standards (GAGAS), the Office of the Inspector General:

- Validated the contractor's independence;
- Assessed their audit plans and methodology;
- Monitored audit performance; and
- Reviewed the report finding, conclusions, and recommendations

Our review disclosed no instances in which Castro & Co. did not comply with GAGAS standards.

Cc:

Chairman Timothy G. Massad,
Commissioner Mark P. Wetjen,
Commissioner Sharon Y. Bowen
Commissioner J. Christopher Giancarlo



**Performance Audit of the Division of Market
Oversight's Rule Enforcement Reviews**

JULY 31, 2015

Prepared by:

Castro & Company, LLC
1711 King Street, Suite C
Alexandria, VA 22314

Table of Contents

NOTIFICATION OF FINDINGS AND RECOMMENDATIONS

<i>Finding No. 1:</i> The Division of Market Oversight Is Not Conducting Rule Enforcement Reviews of All Core Principles	1
<i>Finding No. 2:</i> Procedures for Selecting Designated Contract Market for a Rule Enforcement Review Needs to be Improved.....	4
<i>Finding No. 3:</i> Follow-Up Procedures on Concerns and Recommendations Made in Prior Rule Enforcement Review Reports Needs to be Enhanced	7
<i>Finding No. 4:</i> Inadequate Staffing Leads to Lengthy Rule Enforcement Review Completion Time.....	10

APPENDIX A:

Background Including Description of Rule Review Process.....	14
--	----

APPENDIX B:

Division of Market Oversight Market Compliance Branch Response To Draft Report	22
--	----

NOTIFICATION OF FINDINGS AND RECOMMENDATIONS

Finding No. 1: The Division of Market Oversight Is Not Conducting Rule Enforcement Reviews of All Core Principles

I. Condition

The Division of Market Oversight (DMO) Market Compliance Branch is responsible for monitoring each Designated Contract Market (DCM) to ensure its compliance with the twenty-three (23) Core Principles established within the Commodity Exchange Act. One of the tools used by the Market Compliance Branch to monitor DCMs is regular reviews known as Rule Enforcement Reviews (RERs).

During our audit, we noted that the Market Compliance Branch staff utilized a checklist for each RER conducted. This checklist is structured into five (5) sections and includes a listing of standard questions and procedures that must be asked and/or performed by the Market Compliance Branch staff. When conducting a RER, the Deputy Director of the Market Compliance Branch, through discussion with the Associate Director, will determine which section of the checklist should be completed. Below are the five (5) sections of the checklist with the corresponding seven (7) Core Principles to be reviewed:

I. Staffing and Organization

- ✓ 2 – Compliance with Rules (Focus on DCM’s employees’ ability to perform program compliance activities)

II. Audit Trail

- ✓ 10 – Trade Information
- ✓ 18 – Recordkeeping

III. Trade Practice Surveillance

- ✓ 2 – Compliance with Rules (Focus on the authority, resources, and adequate staffing to enforce rules and verify effective trade practices)
- ✓ 12- Protection of Markets and Market Participant

IV. Market Surveillance

- ✓ 4 – Prevention of Market Disruption
- ✓ 5 – Position Limitations or Accountability

V. Disciplinary

- ✓ 13 – Disciplinary Procedures

Castro & Co noted that the following Core Principles are not being reviewed by the Market Compliance Branch through the RERs:

- | | |
|--|--|
| ✓ 1 – Designation as Contract Market | ✓ 15 – Governance Fitness Standard |
| ✓ 3 – Contract Not Readily Subject to Manipulation | ✓ 16 – Conflicts of Interest |
| ✓ 6 – Emergency Authority | ✓ 17 – Composition of Governing Board of Contracts Markets |
| ✓ 7 – Availability of General Information | ✓ 19 – Antitrust Considerations |
| ✓ 8 – Daily Publication of Trading Information | ✓ 20 – Systems Safeguards |
| ✓ 9 – Execution of Transactions | ✓ 21 – Financial Resources |
| ✓ 11 – Financial Integrity of Transactions | ✓ 22 – Diversity of Boards of Directors |
| ✓ 14 – Dispute Resolution | ✓ 23 – Securities and Exchange Commission (Availability of Records for Inspection and Evaluation by the SEC) |

Though compliance with these Core Principles may be monitored by another branch within DMO, using other tools besides the RER, we did not review any evidence, outside of RERs, that the sixteen (16) above stated, Core Principles are being reviewed and documented by the Market Compliance Branch.

II. Criteria

The Commodity Exchange Act, 7 USC § 7(d)(1) states:

Core Principles for Contract Markets

(1) Designated as contract market

(A) In general

To be designated, and maintained a designation, as a contract market, a board of trade shall comply with –

- i. any core principle described in this subsection; and
- ii. any requirement that the Commission may impose by rule or regulation pursuant to Branch 12a (5) of this title.

The Commodity Exchange Act, 7 USC § 12a (5) states:

The Commission is authorized –

(5) to make and promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of this chapter.

The CFTC's process for conducting RERs is documented in Appendix A.

III. Effect

A partial review of DCM compliance with all Core Principles may hamper DMO's ability to meet CFTC's strategic #1 goal of promoting Market Integrity and Transparency¹.

IV. Cause

Management in DMO's Market Compliance Branch stated that RERs are only one tool they utilize to monitor DCMs compliance with the Core Principles. Other tools are utilized by the Market Compliance Branch and other DMO branches to determine whether DCMs have complied with all the core principles.

V. Recommendation

We recommend that DMO Market Compliance Branch leadership should implement operating procedures that address all the Core Principles DCMs are required to comply with in order to be categorized as a DCM. A standardized checklist will enable the review team to document why a certain Core Principle will not be reviewed. This additional procedure should provide justification supporting the Core Principles selected for review as well as the ones not selected for review so that each RER procedure is formally considered, approved, and documented.

VI. Auditee's Response

DMO stated that the RER program was designed to focus closely on exchanges as the "front-line self-regulatory" organizations in U.S. futures markets and the selection of core principles and regulations for review reflects a conscious decision to focus resources on the areas of greatest risk and maximum reward for market integrity, customer protection, and effective self-regulation. One reason for this approach is due to the limited resources available to DMO.

In addition, DMO stated they utilize several available tools to determine compliance, including lead responsibilities by other Division Branches, the self-regulatory function of the exchanges, and other procedural processes available to the DMO including requiring the exchanges to confirm compliance with core principles upon request. For example, Core Principle 20 – System Safeguards is monitored through System Safeguard Examinations and Core Principle 21 – Financial Resources is monitored by the Market Review Branch.

Finally, DMO stated they will develop an annual process to evaluate and recommend which core principles should be added to the RER program or are more efficiently handled outside of the RER process.

VII. Auditor's Response

Castro & Co agrees with DMO's response and acknowledges, as we did in the finding, that DMO utilizes tools other than RERs and other CFTC units to monitor DCM's compliance with the core principles. We agree with their development of an annual process to evaluate inclusion of additional core principles in the RER program.

¹ See CFTC 2014-2018 Strategic Plan page 10 available at: <http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/2018strategicplan.pdf>

Castro & Co recommends that CFTC's Office of Inspector General (OIG) consider following up on DMO's evaluation of the inclusion of additional core principles within the RERs. For core principles that are not included within the RER process, Castro & Co. recommends that the OIG consider following up on the other tools utilized by DMO to ensure DCM's compliance with core principles.

Finding No. 2: Procedures for Selecting Designated Contract Market for a Rule Enforcement Review Needs to be Improved

I. Condition

The Market Compliance Branch evaluates multiple factors when selecting and prioritizing DCMs to conduct RERs. The factors currently in place for selecting a DCM include the following:

- ✓ Trading volume (significant, moderate, *de minimis*/zero volume);
- ✓ Date when last RER was conducted;
- ✓ Date Market Compliance Branch reviewed the DCM in any other capacity (other than RERs);
- ✓ Significant issues identified in the last RER or other evaluations that required follow-up;
- ✓ Identification of any regulatory issues brought to the attention of the Market Compliance Branch; and
- ✓ Identification of any significant changes in the DCM's compliance program since the last RER or since designated as a DCM.

Based on our review of the factors utilized by the Market Compliance Branch, Castro & Co noted the following issues related to the procedures for selecting a DCM for a RER:

- ✓ The Market Compliance Branch has not established and documented any formalized policies or procedures manual for selecting a DCM for a RER.
- ✓ Selection procedures need to provide specific criteria for choosing DCMs including how the above factors are reviewed and considered in the selection of a DCM.
- ✓ The Market Compliance Branch should specifically define the Tier trading volume levels for Tier 1 - significant, Tier 2 - moderate, and Tier 3 - *de minimis*/zero volume in its policy and procedures to ensure consistency with implementation of the procedures.

In addition, we noted that 20 DCMs were eligible to be reviewed at some point during Fiscal Years 2011 through 2014. The Market Compliance Branch provided a list of these 20 DCMs to the auditors. Castro & Co cross referenced the list of DCMs to information posted on the CFTC website². From the website, we considered all DCMs with the "Designated" status as of a date within Fiscal Years 2011 through 2014 to be an eligible DCM. Also, if a DCM had a status of "Vacated," "Dormant," or "Withdrawn," we reviewed the effective date for such a change in status. If based on its effective date, the DCMs were still active for a portion of the period under

² See

<http://sirt.cftc.gov/SIRT/SIRT.aspx?Topic=TradingOrganizations&implicit=true&type=DCM&status=Vacated&CustomColumnDisplay=TTTTTTTT>.

our review (Fiscal Years 2011 through 2014), then we determined if they were still eligible for a RER.

Based on the above stated factors, we found the Market Compliance Branch reviewed the following DCMs during FY 2011 through 2014:

Tier Level	# of DCMs	# of DCMs Reviewed	# of DCMs Not Reviewed
1	5	6*	-
2	5	4	1
3	10	2	8
Totals	20	12	9

*Note: During Fiscal Years 2011 through 2014, one of the DCMs was reviewed twice.

Though most of the DCMs not reviewed are Tier 3, *de minimis*/zero trading volume, some of these entities have been DCMs since 2010; therefore, we believe that all registered DCMs should be reviewed over a reasonable time period in order to identify potential deficiencies that should be corrected or the reason the DCM will not be reviewed should be documented. A review might ensure that minimal systems and procedures are in place to address a sudden increase in a DCM's business activity. Furthermore, market forces change and newly developed best practices may aid an exchange when it elects to activate its marketplace.

In addition, during the audit, Castro & Co became aware of CFTC filing and settling charges against ICE Futures U.S., a DCM, for submitting inaccurate and incomplete reports and data to the CFTC over the period of October 2012 through May 2014.³ We believe more frequent reviews of all DCMs are necessary to ensure significant issues are identified and either corrected or sanctions being imposed on the DCMs more timely, such as this CFTC action taken against ICE Futures U.S.

II. Criteria

The Commodity Exchange Act, 7 USC § 7(d)(1) states:

Core Principles for Contract Markets

(1) Designated as contract market

(A) In general

To be designated, and maintain a designation, as a contract market, a board of trade shall comply with –

- i. any core principle described in this subsection; and

³ CFTC, *CFTC Orders ICE Futures U.S., Inc. to Pay a \$3 Million Civil Monetary Penalty for Recurring Data Reporting Violations*, Release: PR7136-15 (<http://www.cftc.gov/PressRoom/PressReleases/pr7136-15>).

- ii. any requirement that the Commission may impose by rule or regulation pursuant to Section 8a (5) [7 USC § 12a(5)].

The Commodity Exchange Act, 7 USC § 12a (5) states:

The Commission is authorized –

(5) to make and promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of this chapter.

The CFTC’s process for conducting RERs is documented in Appendix A.

III. Effect

Without sound and specific procedures for selecting DCMs for review, there is a risk that not all DCMs will be reviewed and monitored for compliance with the Commodity Exchange Act.

IV. Cause

The Market Compliance Branch has identified factors that should be evaluated in selecting DCMs for a RER and the Core Principles to be reviewed during the RER. Although we were not provided guidelines on how the factors are weighted in selecting DCMs, the Market Compliance Branch utilizes them as procedures.

V. Recommendation

We recommend that DMO Market Compliance Branch leadership should enhance its procedures for selecting DCMs to be reviewed to include the following:

- ✓ Establish, identify and document selection factors into a formalized policies and procedures manual.
- ✓ Specify in a policies and procedure manual how the factors gathered for each DCM (trading volume, date of last RER or other evaluations, etc.) should be analyzed and weighted to determine which DCM will be selected.
- ✓ Establish specific trading volumes associated with each Tier classification.
- ✓ Specify a period of time (i.e., two (2) to three (3) years) in which a DCM should be reviewed at least once. In addition, the policy could be different for each Tier classification.
- ✓ Working papers should clearly identify the analysis and conclusions reached by the Market Compliance Branch associated with the DCMs selected for review.

VI. Auditee’s Response

DMO agrees that procedures for selecting DCMs for RERs should be better documented; however, they believe that factors associated with the selection process has already been identified and established. The DMO will establish a RER procedures folder and all factors used in conducting a review will be formally documented in that folder, including selection analysis for each RER initiated.

Furthermore, DMO stated that the Commission strives for DMO to examine DCMs deemed most significant on an annual basis (i.e., Tier 1s) and the other DCMs every two to three years. The DMO expects to draft a recommendation within the next 30 days specifying desired frequency of RERs for each tier of DCM; however, this will be a goal due to the limited resources available to the DCM and this goal will not be met without significant additional resources.

VII. Auditor's Response

Castro & Co agrees with the corrective action plan by DMO to establish a RER procedures folder and to utilize this folder to document evaluation of each of the factors when assessing the DCMs for a RER and to document the overall selection analysis for each RER initiated. Castro & Co suggest that a follow-on review should be conducted to ensure that the RER procedures folder is established and is being effectively utilized.

Since DMO believes that the recommended frequency of RERs by the Commission is only a goal and a goal that cannot be obtained without significant additional resources, we recommend that this policy document the recommended goal as well as a more realistic goal considering the current resources of the Market Compliance Branch. This more realistic goal will provide a benchmark for measuring the current Market Compliance Branch. Castro & Co. recommends that the OIG consider evaluating Market Compliance Branch adherence to the enhanced policy.

Finding No. 3: Follow-Up Procedures on Concerns and Recommendations Made in Prior Rule Enforcement Review Reports Needs to be Enhanced

I. Condition

After each RER, the Market Compliance Branch sends a transmittal letter to the DCM with a summary of the concerns and recommendations that emerged from the review. The DCM is required to respond to the DMO within 30 days of the date of the transmittal letter on how they will address the stated concerns and recommendations. During our audit, we were not provided evidence to document any follow-up with the DCMs on their corrective action plan but we noted that the corrective action plan to address these concerns and recommendations are only reviewed during subsequent RERs. Based on our audit, Castro & Co believes the procedures for following up on the concerns and recommendations noted within RERs need to be strengthened to verify that all DCMs' corrective action plans are timely reviewed and addressed prior to a subsequent RER. We were not provided documentation to support ongoing dialogue with DCMs for addressing Market Compliance Branch's recommendations.

II. Criteria

The Commodity Exchange Act, 7 USC § 7(d)(1) states:

Core Principles for Contract Markets

(1) Designated as contract market

(A) In general

To be designated, and maintain a designation, as a contract market, a board of trade shall comply with –

- i. any core principle described in this subsection; and
- ii. any requirement that the Commission may impose by rule or regulation pursuant to Section 8a (5) [7 USC § 12a(5)].

The Commodity Exchange Act, 7 USC § 12a (5) states:

The Commission is authorized –

(5) to make and promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of this chapter.

The CFTC’s process for conducting RERs is documented in Appendix A.

In the case of a DCM that may delegate self-regulatory organizations (SRO) functions to the National Futures Association (NFA) and become aware that a delegated function is not being performed as required under the regulations, the DCMs must take the appropriate actions to address noncompliance, as required by the Commodity Exchange Act. The Commodity Exchange Act, 7 USC § 7a-2(b)(3), states:

COMMON PROVISIONS APPLICABLE TO REGISTERED ENTITIES

(b) Delegation of functions under core principles

(3) Noncompliance

If a contract market, derivatives transaction execution facility, or electronic trading facility that delegates a function under paragraph (1) becomes aware that a delegated function is not being performed as required under this Act, the contract market, derivatives transaction execution facility, or electronic trading facility shall promptly take steps to address the noncompliance.

III. Effect

The Market Compliance Branch practice of only reviewing corrective action plans of previously reported concerns and recommendations during a subsequent RER increases the risk that initially reported concerns and recommendations will not be implemented timely by DCMs due to the following issues:

- ✓ For the FY 2011 through 2014 period, not all of the DCMs received a RER.
- ✓ Infrequent follow-up review will lead to delays in DCMs implementing corrective actions.
- ✓ For the FY 2011 through 2014 period, only one of the DCMs was reviewed more than once.

IV. Cause

The Market Compliance Branch believes the issues discussed within the transmittal letters are not findings that need follow-up on prior to subsequent RERs or the Market Compliance Branch has not maintained and provided support to evidence its follow-up calls to the DCMs to address matters reported within the transmittal letter.

V. Recommendation

We recommend that Market Compliance Branch leadership strengthen procedures for following up promptly on all concerns and recommendations issued to a DCM. These procedures should consider, at a minimum, the following:

- ✓ In consultation with a DCM, establish a time period for the corrective action plans to be implemented.
- ✓ Establish scheduling guidelines based on the severity of the concerns and recommendations for Market Compliance Branch follow-up on corrective action plans to determine whether a reviewed DCM has promptly addressed matters identified during the RER.

VI. Auditee's Response

Though DMO agrees with the value associated with following up with a DCM to address recommendations and concerns identified in the DMO's RER transmittal letter prior to a subsequent RER, it disagrees with the assertion that a DCM's corrective action plan is only reviewed during the subsequent RER. DMO further states while they do not have a fixed timetable for RER follow-up, the staff verbally provided several examples of the follow-up conducted with DCMs following their response letters and prior to any subsequent RER. DMO stated they will better document its follow-up process and will maintain the documentation in the appropriate electronic RER folder.

Finally, the DMO stated its current practice includes direction within the transmittal letters requiring a DCM to respond within 30 days regarding how it will address recommendations or deficiencies. Moving forward, DMO stated, they will include language in the transmittal letters requiring a DCM's response to include specific timeline in which the DCM plans to address each recommendation and/or correct any deficiency. Upon review of the DCM's corrective action plan, DMO will communicate any concerns to the DCM. The transmittal letter will also require the corrective action plan to be implemented as soon as practical and for DCMs to provide DMO with information sufficient to demonstrate that the action plan has been implemented.

VII. Auditor's Response

Castro & Co agrees with DMO's corrective action plan to better document the follow-up process and to maintain proper documentation within the RER folder. In addition, Castro & Co. agrees with the language to be included within the transmittal letter requiring DCM to provide a specific timeline for addressing recommendations and/or deficiencies, as well as providing information to DMO to demonstrate that the action plan has been implemented. Castro & Co further recommends that the OIG consider conducting follow-up procedures to ensure that the procedures have been properly implemented.

Finding No. 4: Inadequate Staffing Leads to Lengthy Rule Enforcement Review Completion Time

I. Condition

DMO's goal is to foster derivatives markets that accurately reflect the forces of supply and demand and are free of disruptive activity. It oversees trade execution facilities and data repositories, conducts surveillance, reviews new exchange applications and examines existing exchanges to ensure compliance with applicable core principles. DMO also evaluates new products to examine susceptibility to manipulation as well as rule filings by exchanges to ensure compliance with core principles. These responsibilities are addressed by employees in various DMO branches.

Castro & Co noted that the limited number of full-time employees within the Market Compliance Branch might have an effect in the following areas:

- ✓ Number of RERs conducted – new RERs are assigned to Market Compliance Branch staff as determined by the Deputy Director.
- ✓ RERs are not being concluded in a timely manner –Market Compliance Branch sets a goal of one (1) year to complete each selected RER. Of the 12 (twelve) RERs conducted during the period FY 2011 through FY 2014, only one of the RERs was completed within one year. On average, twelve (12) were completed within one year and eight months with the longest being completed in two years and ten months. Castro & Co performed an analysis of the period of time to complete RERs using the Initiation letter date as the start date of the RER and the date of the RER report as the end date. See the table below:

#	Designated Contract Market	Tier Level	Start Date	End Date	Period of Time to Complete RER	
					Days	Years/Month
1	CBOE Futures Exchange	2	11/15/2010	09/06/2013	1,026	2 years 10 months
2	Chicago Board of Trade	1	11/21/2011	07/29/2013	616	1 year 8 months
3	Chicago Mercantile Exchange	1	11/21/2011	07/29/2013	616	1 year 8 months
4	Commodity Exchange	1	12/11/2009	08/30/2011	627	1 year 9 months
5	ELX Futures	3	06/21/2012	09/06/2013	442	2 years 3 months
6	ICE Futures U.S.	1	06/21/2012	07/22/2014	761	2 years 1 month
7	ICE Futures U.S.	1	11/10/2011	12/17/2012	403	1 year 1 month
8	Minneapolis Grain Exchange	2	06/13/2012	09/06/2013	450	1 year 3 months
9	New York Mercantile Exchange, Inc.	1	12/11/2009	08/30/2011	627	1 year 9 months
10	North American Derivatives Exchange	2	12/18/2012	11/19/2013	336	11 months
11	NYSE LIFFE, U.S.	3	11/05/2010	04/23/2012	535	1 year 5 months
12	One Chicago, LLC	2	6/28/2012	04/07/2014	648	1 year 10 months
Totals					7,087	19 years 5 months
Average					591	1 year 8 months

Management informed the audit team that factors which can affect RER completion time include delays in the exchange of information between Market Compliance Branch

employees and the DCM, and workload constraints on Market Compliance Branch employees.

During our review, Castro & Co requested a report of the total hours charged to tasks by employees in the Market Compliance Branch for FY 2011 through FY 2014, which included employees that no longer work in the Market Compliance Branch. For each fiscal year, hours were provided and we identified the different hours billed to the DCMs by each employee as “class 1” associated with conducting the RERs and the total hours charged by the Market Compliance Branch. In addition, for FY 2013 and 2014, we were provided the hours charged, but not billed to the DCMs, by each employee as “class 2” associated with conducting the RERs.⁴ The table below shows the hours charged to “class 1”, “class 2”, total hours, and the number of RERs completed during the fiscal year:

Description	FY 2011	FY 2012	FY 2013	FY 2014
Class 1 Hours	1,022	3,686	6,796	1,926
Class 2 Hours	-	-	13,730	8,492
Total Hours Charged	20,691	24,620	38,254	29,169
Total RERs Completed	2	1	6	3

II. Criteria

The Commodity Exchange Act, 7 USC § 7(d)(1) states:

Core Principles for Contract Markets

(1) Designated as contract market

(A) In general

To be designated, and maintained a designation, as a contract market, a board of trade shall comply with –

- i. any core principle described in this subsection; and
- ii. any requirement that the Commission may impose by rule or regulation pursuant to Branch 12a (5) of this title.

The Commodity Exchange Act, 7 USC § 12a (5) states:

The Commission is authorized –

(5) to make and promulgate such rules and regulations as, in the judgment of the Commission, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of this chapter.

We did not document a standard completion cycle for RERs.

⁴ The hours reported by employees are self-reported and we were unable to confirm with each employee the accuracy of the hours entered into the payroll system. Nonetheless, this was the best available information for ascertaining staff hours charged to an RER and does take into consideration annual leave and training hours.

III. Effect

Inadequate staffing increases the risk that the DMO will not meet an overall objective of market oversight. In addition, if the RERs can be completed within a year, the issues noted within the RERs can be addressed sooner by the DCMs or referred to the Division of Enforcement (for more significant issues) to minimize subsequent impact of the open issues.

IV. Cause

Due to delays in the exchange of information between the Market Compliance Branch and DCMs and other tasks required of the individuals completing the RER, employees may have developed a reduced sense of urgency to finalize the open RER.

V. Recommendation

We recommend that DMO Market Compliance Branch leadership:

- ✓ Determine whether more staff is needed to timely complete RERs or establish the frequency for conducting RERs with existing staff so as to provide timely results to DCMs.

Or

- ✓ Enhance procedures on how RERs are monitored by the Deputy and Associate Directors of Market Compliance Branch by establishing the use of budgets for each RER and/or implementation of strict timeline for the completion of the RER.
- ✓ Procedures should be enhanced to require DCMs to be more responsive to the Market Compliance Branch's request for information. These and other procedures should be implemented with the purpose of ensuring RERs are completed on a timelier basis.

Strengthen the procedures for selecting DCMs and the specific core principles to be reviewed during the RER, as discussed in Findings 1 and 2, to ensure the DCMs and core principles which pose the most operational risk are timely reviewed.

VI. Auditee's Response

DMO stated that they agree with the finding that inadequate staffing within the Market Compliance Branch leads to lengthy completion times for RERs. In addition to inadequate staffing, DMO points out that the RER program has been impacted in fiscal years 2011 through 2014 by extensive rulemaking and other responsibilities arising from implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act by requiring a significant portion of time from compliance attorneys who otherwise would have been leading RERs. These rulemaking projects have continued into fiscal year 2015 and DMO anticipates it will continue into fiscal year 2016. Given the above constraints, DMO stated they are committed to fulfilling their oversight responsibilities.

VII. Auditor's Response

Castro & Co agrees that the Market Compliance Branch is inadequately staffed and acknowledges that rulemaking projects significantly reduced the amount of resources available for conducting and completing RERs; however, Castro & Co. reiterates our recommendations to enhance procedures for monitoring RERs and for following up with DCMs.

APPENDIX A:

BACKGROUND INCLUDING DESCRIPTION OF RULE REVIEW PROCESS

Background

The CFTC was created by Congress in 1974 as an independent agency with the mandate to regulate the commodity futures and options market in the United States. The Agency protects market participants against manipulation, abusive trade practices and fraud. Through effective oversight and regulation, the CFTC enables the markets to serve better their important functions in the nation's economy – providing a mechanism for price discovery and a means of offsetting price risk.

To assist the financial and market integrity of the nation's futures markets, the CFTC reviews the terms and conditions of proposed futures and option contracts. All futures and options transactions must be conducted on or subject to the rules of a CFTC designated board of trade. Before an exchange lists a new futures or options contract for trading, it must certify that the contract complies with the requirements of the Commodity Exchange Act (CEA) and the Commission's regulations, including the requirement that the contract terms reflect commercial trading practices and that the contract not be readily susceptible to manipulation. The CFTC conducts daily market surveillance and can, in an emergency, order an exchange to take specific action or to restore orderliness in any futures contract that is being traded.

Companies and individuals who handle customer funds or give certain trading advice must apply for registration through the NFA, a self-regulatory organization approved by the Commission. The CFTC also seeks to protect customers by requiring registrants to disclose market risks and past performance information to prospective customers, by requiring customer funds be kept in accounts separate from those maintained by the firm for its own use, and by requiring customer accounts to be adjusted to reflect the current market value at the close of trading each day. In addition, the CFTC monitors registrant supervision systems, and internal controls and sales practice compliance programs.

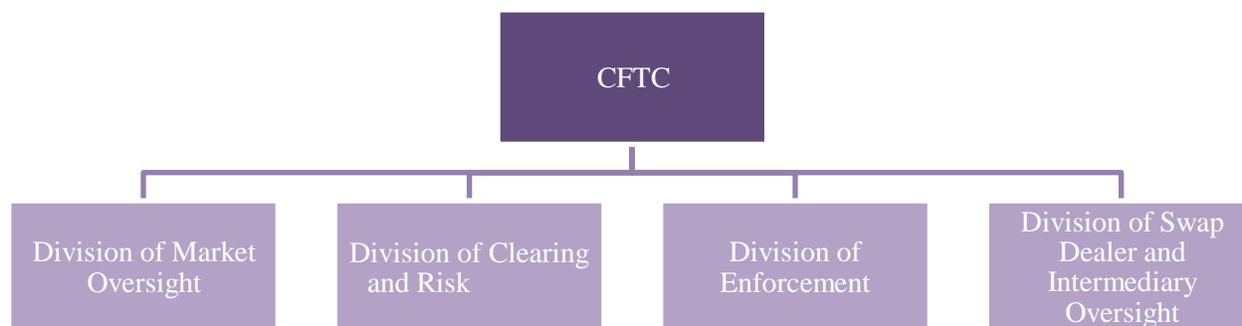
Commodity exchanges complement Federal regulation with rules of their own, rules covering clearance of trades, trade orders and records, position limits, price limits, disciplinary actions, floor trading practices, and standards of business conduct. A new or amended exchange rule may be implemented upon certification by the exchange that the new or amended rule complies with the CEA and Commission regulations. The CFTC may also direct an exchange to change its rules or practices if found to be in violation. The NFA, a self-regulatory organization for the U.S. futures industry, performs similar functions for member firms. The CFTC also regularly reviews each exchange's and the NFA's compliance program.

The Commission consists of five Commissioners, appointed by the President with the advice and consent of the Senate to serve staggered five-year terms. The Commission develops and implements agency policy and direction. One of the Commissioners is designated by the President to serve as Chair. The Chair's staff has direct responsibility for providing information about the Commission to the public and interacting with other governmental agencies and the Congress, and for the preparation and dissemination of Commission documents. The Chair's staff also ensures that the Commission is responsive to requests filed under the Freedom of Information Act and Privacy Act.

The CFTC monitors markets and market participants by maintaining, in addition to its headquarters office in Washington, DC, offices in Chicago, New York, and Kansas City. In

addition, the CFTC operates through four different divisions listed below and are supported by a number of offices not listed in this abridged chart:

Figure 1



- ✓ **Division of Market Oversight (DMO)** – fosters derivatives markets that reflect the forces of supply and demand and are free of disruptive activity. The DMO is also responsible for performing RERs on DCMs.
- ✓ **Division of Clearing and Risk** – oversees derivatives clearing organizations and other market participants in the clearing process, including futures commission merchants, swap dealers, major swap participants, and large traders.
- ✓ **Division of Enforcement** – investigates and prosecutes alleged violations of the CEA and CFTC regulations. Potential violations include fraud, manipulation and other abuses concerning commodity derivatives and swaps that threaten market integrity, market participants, and the general public. Successful prosecution by the Division of Enforcement can result in a court imposed financial sanction -- known as a civil monetary penalty.
- ✓ **Division of Swap Dealer and Intermediary Oversight** – oversees the registration and compliance of intermediaries and futures industry self-regulatory organizations, including U.S. derivatives exchanges and the National Futures Association.

On July 21, 2010, the “Dodd-Frank Wall Street Reform and Consumer Protection Act” (the Dodd-Frank Act, or the Act) was signed into law, significantly expanding the powers and responsibilities of the CFTC to also include oversight of the swaps markets.

Designated Contract Markets

DCMs are boards of trade, i.e. exchanges, which may list for trading futures or option contracts based on all types of commodities and grant access to their facilities by all types of traders. To obtain and maintain its designation, a DCM must comply, on an initial and ongoing basis with twenty-three (23) Core Principles established in Section 5(d) of the CEA, 7 USC 7(d) and Part 38 of the CFTC’s regulations and with the implementing regulations under Part 38 of the CFTC’s regulations.

The Dodd-Frank amendments of the CEA included the following:

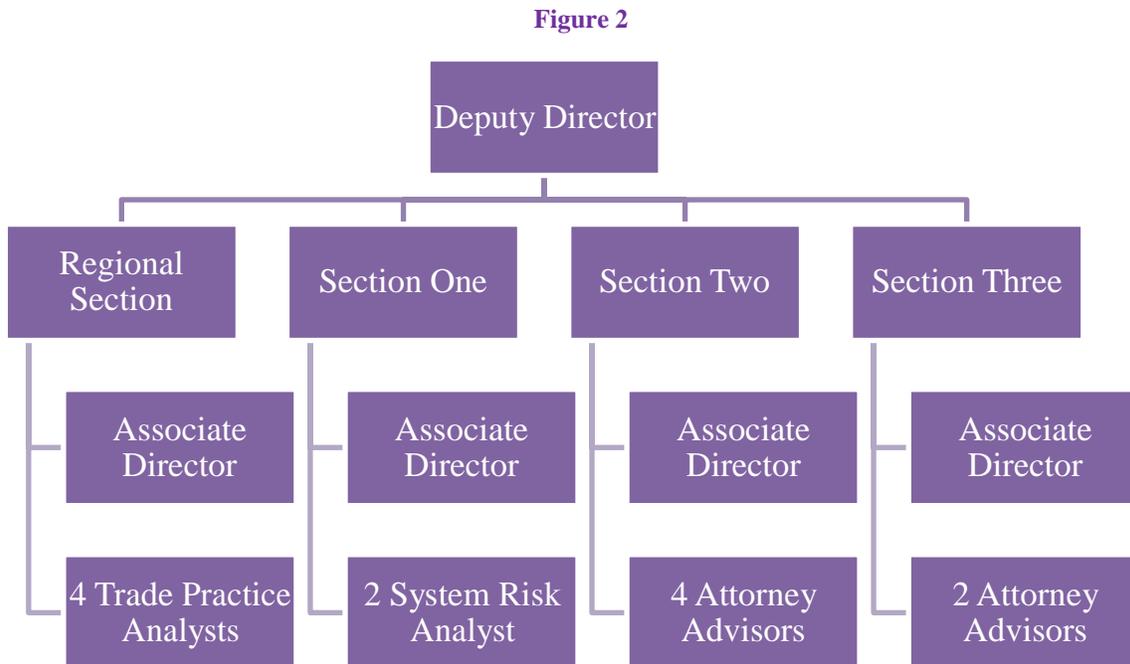
- ✓ Section 735 of the Dodd-Frank Act amended CEA by eliminating the eight criteria for designation as a contract market under Section 5(b);
- ✓ Amended a majority of the core principles, including incorporating into the Core Principles most of the former designation criteria; and, added five new core principles: Core Principle 13 (Disciplinary Procedures), Core Principle 20 (System Safeguards), Core Principle 21 (Financial Resources), Core Principle 22 (Diversity of Boards of Directors), and Core Principle 23 (Securities and Exchange Commission).
- ✓ Section 723 of the Dodd-Frank Act added Section 2(h)(8) of the CEA to require that the execution of swaps, those that are subject to the mandatory clearing requirement of CEA Section 2(h), occur on DCMs or Swap Execution Facilities (SEF), except where no DCM or SEF makes the Swap available for trading.

The CFTC approved new rules for DCMs that became effective on August 20, 2012.⁵ All of these requirements (e.g., CFTC’s regulations, application guidance, acceptable practices, and the new approved rules) implement the twenty-three (23) core principles, and incorporate the trading and execution of swaps on DCMs.

Rule Enforcement Reviews of Designated Contract Market Process

DMO’s Market Compliance Branch is headed by a Deputy Director who oversees four organizational units which are: Regional Section, Section One, Section Two, and Section Three.

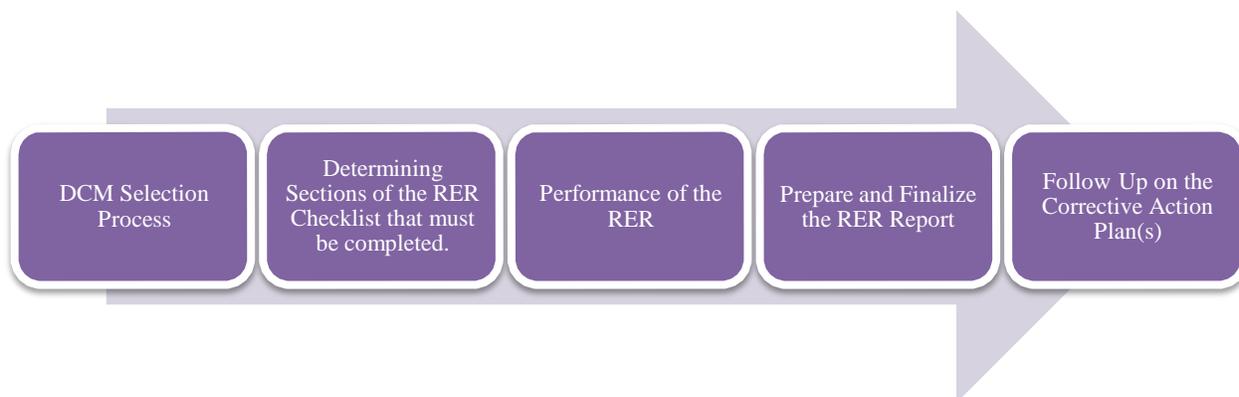
Below is an overview of the Market Compliance Branch:



⁵ 77 FR 36611 (June 19, 2012).

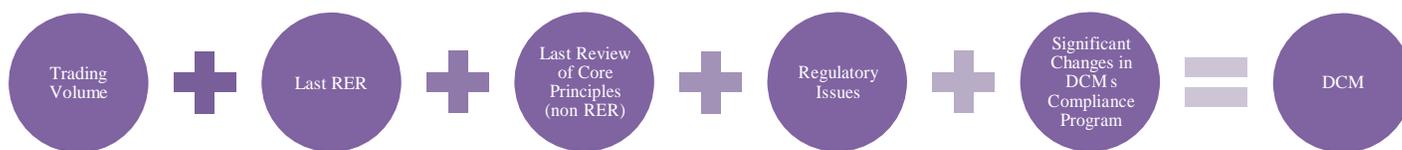
Market Compliance Branch is responsible for conducting regular reviews of each DCM’s ongoing compliance with core principles through the self-regulatory programs operated by the exchange in order to enforce its rules, prevent market manipulation and customer and market abuses, and ensure the recording and safe storage of trade information. These reviews are known as RERs. Each RER will include the examination of trading and compliance activities over a twelve (12) month period immediately preceding the start of the review. The process for conducting a RER is summarized below:

Figure 3



Designated Contract Markets RER Selection Process

Figure 4



When it is determined that an RER needs to be conducted, the Deputy Director will meet with the Associate Directors of the Regional Section, Section Two and Section Three. These individuals will analyze several factors before selecting a DCM for a RER. These factors include the following:

- ✓ Trading Volume on the DCM, which are identified as:
 - Tier 1 - significant volume transactions;
 - Tier 2 - moderate volume transactions; and
 - Tier 3 - zero or *de minimis* volume transactions).
- ✓ Last time a review was conducted on the DCM in any capacity. These reviews may include reviews completed by other divisions of the DMO related to product; market; data and reporting; business management; and market and contract analysis reviews. Additionally, they may discuss reviews related to Core Principle 20 (System Safeguards), which is performed by Section One of the DMO Market Compliance Branch.

- ✓ Last time a particular Core Principle was reviewed at the DCM through an audit trail, trade practice surveillance, market surveillance, and disciplinary procedures. Any issues identified in a previous RER performed on a DCM that require follow up to evaluate implementation of recommendations or areas that require corrective action due to a deficiency with a CFTC regulation.
- ✓ Any regulatory issues brought to the attention of the Market Compliance Branch.
- ✓ Any significant changes in the DCMs Compliance program since the last RER or DCM registration. DCMs are required to notify the CFTC of any significant changes in their compliance program.

The Deputy Director and the Associate Director will also consult with other CFTC divisions to ensure there are not any duplication of efforts before the final determination is made on selection of a DCM for conducting an RER.

Process for Selecting Sub-Section of the RER Checklist to Review

Figure 5

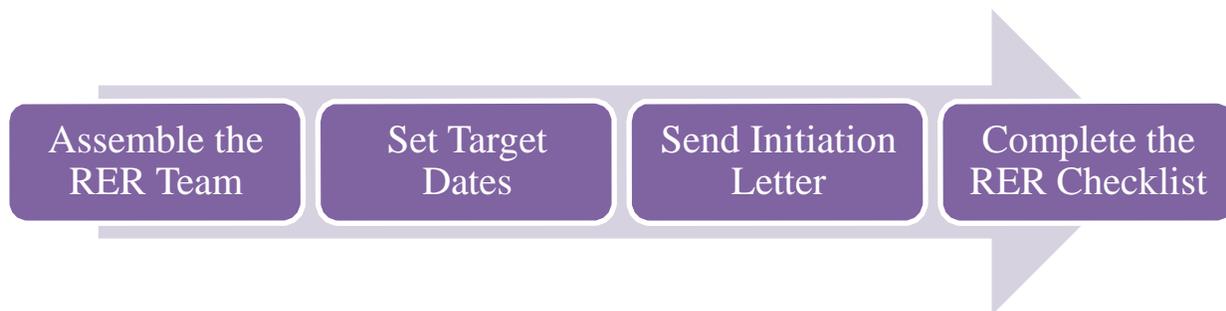
RER Checklist				
Staffing and Organization	Audit Trail	Trade Practice Surveillance	Market Surveillance	Disciplinary

The Market Compliance Branch utilizes a checklist for completing RER on a selected DCM. This checklist is structured into five (5) sections and includes a listing of questions and/or procedures that must be asked and/or performed in order to complete the specified RER checklist section. The separate sections of the checklist are: 1) Staffing and Organization, 2) Audit Trail, 3) Trade Practice Surveillance, 4) Market Surveillance, and 5) Disciplinary. Each of the separate sections of the RER checklist is designed to address one or more core principles.

Before conducting a RER, the Market Compliance Branch will determine which sections of the checklist must be completed. Some guidelines utilized by the Market Compliance Branch include sections of the checklist that are not usually reviewed in consecutive years for a specific Tier 1 DCM, unless significant findings or deficiencies were identified. In addition, for Tiers 2 and 3 DCMs, a RER for a specific section of the checklist will not be repeated for review until the other sections of the checklist have been reviewed also.

Conducting a RER

Figure 6



The Market Compliance Branch will assign staff to conduct RERs based on availability and skillset required. The team is generally made up of a lead attorney either from Section Two or Three and a trade practice analyst from the Regional Section. All RERs are supervised by the Deputy Director and the Associate Director. Also, if a market surveillance review is being performed, the Market Compliance Branch will request assistance and support from the DMO Market Surveillance Section.

The Associate Director and the RER team will set target dates for completing the various stages of the RER, including completing the applicable checklist sections and the written transmittal letter. Once the target dates are set, the RER team will send an initiation letter to the DCM to notify them about the RER, the sections of the checklist to be performed, and the applicable target dates for starting the RER.

The RER team completes the applicable sections of the RER checklist by examining trading and compliance activities for the DCM over the twelve (12) months preceding the date of the initiation letter. The review period can be expanded to subsequent periods if issues are identified which would require further evaluation and analysis. More specifically, the RER team conducts an extensive review of documents and systems used by the DCM, including but not limited to the following:

- ✓ Organizational charts
- ✓ Qualifications of compliance staff
- ✓ Compliance manuals
- ✓ Reports and other documents used routinely for surveillance
- ✓ Investigation files and logs
- ✓ Disciplinary files and logs
- ✓ Committee meeting minutes involving compliance functions.

On site, the lead attorney performs interviews with the DCM personnel, who are recorded and transcripts of the interviews are documented by a court reporter. DCMs have the ability to review the transcripts and correct any inaccuracies, if any. The lead attorney and trade practice analyst will complete the applicable sections of the RER checklist to support the information obtained from the DCM. The RER checklist represents the main source for writing the report.

Prepare and Finalize the RER Report

Figure 7



Once the checklist has been completed by the RER team, a comprehensive RER report is drafted by the lead attorney. The RER report describes the DCM’s compliance program and includes an analysis of the DCM’s compliance with the relevant core principles and CFTC regulations. In addition, the RER report includes findings as a result of the review with recommendations for areas of improvement. A draft of the RER report is reviewed and edited by an Associate Director and Deputy Director. A draft is also sent to the Division of Enforcement for its review and comments.

Once reviewed and approved, the final draft is sent to the DCM and an exit conference is conducted to discuss the RER report. Then the RER report is submitted to the CFTC Commissioners for acceptance. After the Commission accepts the report, the report, along with a press release is issued and made public through the CFTC website (www.cftc.gov).

Follow-Up on the Corrective Action Plan(s)

Figure 8



A response to the transmittal letter is required from the DCM within 30 days of issuance and the DCM’s response should address how the DCM plans to correct any deficiencies and/or implement recommendations. The Market Compliance Branch will communicate with the DCM frequently to ensure all corrective action plans are being implemented and will conduct follow up procedures for deficiencies reported on subsequent RERs.

APPENDIX B:

**DIVISION OF MARKET OVERSIGHT MARKET COMPLIANCE BRANCH
RESPONSE TO DRAFT REPORT**



Division of
Market Oversight

U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5260
Facsimile: (202) 418-5527
www.cftc.gov

To: Tony Baptiste, Senior Program Analyst
Office of the Inspector General

From: Vincent McGonagle, Director 
Rachel Berdansky, Deputy Director 
Division of Market Oversight

Re: Performance Audit of the Division of Market Oversight's Rule Enforcement Review
Program

Date: July 2, 2015

The Division of Market Oversight ("Division") appreciates the opportunity to respond to the Performance Audit conducted by Castro & Company, LLC on behalf of the Office of the Inspector General of the Division's Rule Enforcement Review Program ("Castro Report"). The Division effectively uses its rule enforcement review ("RER") program as an oversight tool and welcomes suggestions for further enhancement. The Division is pleased that the Castro Report agrees with the Division's approach of reviewing those designated contract markets ("DCMs") and core principles which pose the most risk. The Castro Report made four specific findings with related recommendations. The Division intends to implement those recommendations. All of the Castro Report's findings and the Division's adoption of the Castro Report's recommendations are discussed below.

Finding 1: The Division Is Not Conducting Rule Enforcement Reviews of All Core Principles

The Castro Report found that the Division's RER program is designed to focus on those core principles and Commission regulations related to four areas: audit trail, trade practice surveillance, market surveillance, and exchange disciplinary programs. In addition, all RERs, regardless of subject area being examined, review the exchange's staffing and organization in that subject area to determine whether the exchange has adequate staff and resources to perform its self-regulatory functions. The Division agrees with these findings. The RER program was designed from its inception to focus closely on exchanges as the front-line self-regulatory organizations in U.S. futures markets. The Division's selection of core principles and regulations for review in RERs reflects a conscious decision to focus resources on the areas of greatest risk and maximum reward for market integrity, customer protection, and effective self-regulation.

The Castro Report also states that the Division’s Market Compliance Branch (“Compliance”) is responsible for reviewing exchange compliance “with the twenty-three (23) Core Principles established within the Commodity Exchange Act.” However, the Division utilizes several available tools to determine compliance, including lead responsibilities by other Division Branches, the self-regulatory function of the exchanges, and other procedural processes available to the Division requiring the exchanges to confirm compliance with core principles upon request. Notwithstanding, the Division will evaluate whether and which additional core principle reviews may be effectively subject to a rule enforcement review.

A. RERs Are Not Optimal for all Core Principles

As a general matter, the Castro report does not independently evaluate whether and how each of the core principles is suitable for a rule enforcement review. The Division has determined that given resource limitations, the Compliance Branch’s RER program will focus on DCMs compliance with those core principles related to subject areas that are likely to pose the most risk to the general public. At this time, this includes audit trail (Core Principle 2- Compliance with Rules and Core Principle 10- Trade Information); trade practice surveillance (Core Principle 2 and Core Principle 12- Protection of Market Participants); market surveillance (Core Principle 2, Core Principle 4- Monitoring of Trading, and Core Principle 5- Position Limitation or Accountability); and exchange disciplinary programs (Core Principle 13- Disciplinary Procedures).

Presently, the Division has determined that oversight of some core principles is better addressed outside of the RER process. The Castro Report lists specific core principles for which Compliance does not conduct RERs. Included in that list is Core Principle 20- System Safeguards. The Division notes, however, that the Compliance Branch includes a dedicated Market Continuity Program that conducts System Safeguard Examinations (“SSEs”) specifically to review DCMs’ compliance with Core Principle 20. The Division also has determined that DCM compliance with Core Principle 18- Recordkeeping, which in the past was addressed in audit trail RERs, is better addressed in SSEs.

For certain core principles, the Division believes it is a more effective and efficient use of resources for other Division Branches to have lead responsibility to conduct oversight. For example, Core Principle 21- Financial Resources, is a core principle that the Division has determined is more efficiently handled by the Market Review Branch outside of the RER process, rather than by Compliance. Market Review oversees the designation of DCMs (an applicant must demonstrate compliance with all of the core principles to be designated as a contract market), and thereafter, the market activities and functions of DCMs by reviewing rule filings and submissions.¹ With respect to Core Principle 21, Commission regulation § 38.1101(f)

¹ Part 40 of the Commission’s regulations requires that before implementing any new rule, a DCM must either submit the rule for approval or self-certify that the rule complies with the Act and Commission regulations. The term “rule” is defined broadly and pursuant to § 40.1(i) includes “any constitutional provision, article of incorporation, bylaw, rule, regulation, resolution, interpretation, stated policy, advisory, terms and conditions, trading protocol, agreement or instrument corresponding thereto, including those that authorize a response or

requires that DCMs file detailed quarterly reports regarding financial resources.² Market Review assesses each DCM's quarterly report to determine whether the DCM is in compliance with the core principle and its associated rules. Given that this assessment is made four times a year, the Division believes that conducting a Core Principle 21 RER is redundant and not a prudent use of limited resources. For some core principles, such as Core Principle 19- Antitrust Considerations, the Division has determined that at present, oversight is best accomplished through the rule submission process that is handled by the Market Review Branch.

Core Principle 3- Contracts Not Readily Subject to Manipulation, is a program area to which the Division has devoted an entire (separate) Branch: the Product Review Branch. Under Part 40 of the Commission's regulations, a DCM cannot list a product for trading that has not been either self-certified by the DCM that the product complies with the Commodity Exchange Act ("Act") and Commission regulations, or approved by the Commission pursuant to a request by the DCM. The vast majority of new products are self-certified.³ In reviewing new product

establish standards for responding to a specific emergency, and any amendment or addition thereto or repeal thereof, made or issued by a registered entity or by the governing board thereof or any committee thereof, in whatever form adopted." Accordingly, rules are submitted in connection with all core principles, including core principles that may not be reviewed in an RER. Market Review's evaluation of rule filings thus serves as another Division tool to evaluate DCM's core principle compliance. Commission regulation § 40.6(a)(7)(v) requires that rule certifications include an explanation of the operation, purpose, and effect of the proposed rule or rule amendment, and its compliance with the Act and Commission regulations.

² Commission regulation § 38.1101(f) provides as follows:

(f) *Reporting Requirements.* (1) Each fiscal quarter, or at any time upon Commission request, a designated contract market must:

(i) Report to the Commission:

(A) The amount of financial resources necessary to meet the requirements of paragraph (a) of this section; and

(B) The value of each financial resource available, computed in accordance with the requirements of paragraph (d) of this section; and

(ii) Provide the Commission with a financial statement, including the balance sheet, income statement, and statement of cash flows of the designated contract market or of its parent company.

(2) The calculations required by this paragraph shall be made as of the last business day of the designated contract market's fiscal quarter.

(3) The designated contract market must provide the Commission with:

(i) Sufficient documentation explaining the methodology used to compute its financial requirements under paragraph (a) of this section;

(ii) Sufficient documentation explaining the basis for its determinations regarding the valuation and liquidity requirements set forth in paragraphs (d) and (e) of this section; and

(iii) Copies of any agreements establishing or amending a credit facility, insurance coverage, or other arrangement evidencing or otherwise supporting the designated contract market's conclusions.

(4) The reports shall be filed not later than 40 calendar days after the end of the designated contract market's first three fiscal quarters, and not later than 60 calendar days after the end of the designated contract market's fourth fiscal quarter, or at such later time as the Commission may permit, in its discretion, upon request by the designated contract market.

³ Commission regulation § 40.2(a)(3)(v) requires that the certification include an explanation and analysis of the product and its compliance with the Act and Commission regulations. The explanation and analysis must be

submissions, Product Review is particularly focused on Core Principle 3. Given that over 2,400 different products traded in each of the past three years (2012, 2013, and 2014), the Division believes it is impractical to determine compliance with Core Principle 3 through the RER process.

The Division notes that Commission regulation § 38.5(b) is another mechanism used by the Division, outside of the RER process, to determine whether a DCM is in compliance with core principles. Pursuant to delegated authority, that regulation permits the Division to request that a DCM file a written demonstration, containing supporting data and documents, that demonstrate the DCM is in compliance with one or more core principles. Several of the Division's Branches, including Compliance, have utilized this process upon learning of potentially problematic exchange practices or procedures through the Branches' routine work. Moreover, if a DCM rule on its face appears to comply with the Act and Commission regulations but Division staff is concerned regarding its actual operation and market impact, the Division will utilize § 38.5(b) and request that the DCM demonstrate its compliance with the potentially impacted core principles and/or Commission regulations.

B. Resource Limitations

The Division acknowledges that with more staff, additional core principles, such as those related to governance, would be included in the RER program. As recognized by the Castro Report in Finding 4 (addressed more fully below), Compliance is constrained by limited resources— most specifically the number of staff. Given that limited staffing is a chronic issue (not only for Compliance, but for the entire Division), the Division has made a strategic decision to structure its RER program to focus on those core principles that it believes are likely to pose the most risk to the general public and areas that are the most fluid, e.g., the effectiveness of exchange trade practice and market surveillance programs, the adequacy of exchange investigations, and the sufficiency of exchange-imposed sanctions for violations of rules or law. While the Division is responsible for oversight of all of the core principles, RERs are only one of the many tools available to the Division to perform its oversight responsibilities.

Castro Report Recommendation: Compliance Branch leadership should implement operating procedures that address all of the DCM Core Principles. A standardized checklist will enable the review team to document why a certain Core Principle will not be reviewed. This additional procedure should provide justification supporting the Core Principles selected for review as well as the ones not selected for review so that each RER procedure is formally considered, approved, and documented.

The Division has determined that DCM compliance with certain core principles is more effectively analyzed and reviewed by other Branches and that further review by Compliance RERs will likely be duplicative and unnecessarily divert scarce resources from the core areas for

accompanied by the documentation relied upon to establish the basis for compliance, or incorporate information contained in such documentation with appropriate citations to data sources.

which RERs have been deemed to be the most effective oversight tool. However, the Division agrees that it will develop an annual process to evaluate and recommend which DCM core principles not routinely included in the RER program should be added to the program in that year, if any. This recommendation process will include senior Compliance staff consultation with the Division Director and Division Deputy Directors to discuss: market changes that warrant adding a particular core principle to the RER program; consideration of Commission rules recently adopted in connection with a particular core principle; the risk to market participants if the core principle is not included in the program; resources; and other Division priorities and considerations. A determination also will be made if DCM compliance with the core principle is more efficiently handled outside of the RER process. This process will be implemented by the Division prior to the initiation of any new RERs and documented in a checklist as recommended. The documentation, however, will recognize that what the Division believes poses the most risk could change at any time, depending on circumstances. Documenting the selection of those core principles selected for a specific DCM review will be addressed in the Division's response to the Castro Report's recommendation made in connection with Finding 2.

Finding 2: Procedures for Selecting DCMs for an RER Need to be Improved

The Compliance Branch provided Castro with a list of the factors Compliance considers in selecting a particular DCM for an RER. The Castro Report cites these factors but nevertheless concludes that Compliance has not "established and documented any formalized policy or procedures manual for selecting a DCM for a RER." The Castro Report further concludes that Compliance's selection procedures need to provide specific criteria for choosing DCMs and how those factors are reviewed and considered in the selection process. The Division agrees that documentation of the selection for a DCM RER can be better documented. The Division, however, disagrees with any implication that Compliance has not established a formalized policy for DCM selection and that Compliance does not have specific criteria that it considers for DCM RER selection.

The Castro Report explains how Compliance divides DCMs into different tiers depending upon trading volume. A DCM's tier level is one factor considered when selecting a DCM for an RER. DCMs with significant trading volume are considered Tier 1, DCMs with moderate trading volume are considered Tier 2, and DCMs with de minimis or zero trading volume are considered Tier 3. The Castro Report concludes that Compliance should define the trading volume levels for each tier.

The Castro Report also discusses the number of DCMs subject to an RER during the relevant review period (FY 2011-FY 2014). The report notes that most of the DCMs not examined during the review period had de minimis or zero trading volume and that some of these Tier 3 exchanges had not been examined since designation dating back to 2010. The report explains that an RER "might ensure that minimal systems and procedures are in place to address a sudden increase in a DCM's business activity." While it is the Division's goal to perform RERs of all DCMs on a regular basis, as recognized by the Castro Report, the Division is constrained by

limited staff resources. Further, DCMs are diligently examined for compliance with all core principles during the designation process. Any changes in systems or procedures must be filed as a rule submission and are reviewed by Market Review and/or Compliance.⁴

RERs are an effective tool for measuring a particular DCM's compliance with specific core principles and also are an effective tool to establish best practices that are frequently adopted by other exchanges. RERs are published on the Commission's website and are therefore available to be read by all DCMs. It is not uncommon for several exchanges, including newly designated exchanges, to file rule changes after issuance of another exchange's RER.

The Castro Report mentions the Commission's settlement of charges with ICE Futures U.S. ("ICE") for submitting inaccurate and incomplete reports and data to the Commission for the period of October 2012-May 2014. The report states that "more frequent reviews of all DCMs are necessary to ensure significant issues are identified and either corrected or sanctions being imposed on the DCM more timely, such as this CFTC action. . . ." The Division agrees that more frequent RERs of DCMs is important and it continues to request more resources for this purpose. However, the case involving ICE demonstrates that the Division does not rely solely on RERs (nor does the Commission rely solely on the Division) for identifying DCM compliance issues. A referral regarding ICE's reporting issues was made by the Commission's Office of Data and Technology ("ODT") to the Division of Enforcement ("DOE") in July 2013. The Division's Surveillance and Compliance Branches were both aware of ICE's reporting issues to the Commission as early as when that referral was sent to the DOE. Moreover, the Division's Surveillance Branch (with Compliance's knowledge) further supplemented ODT's referral with its own DOE referral in October 2013.⁵ Coincidentally, during the period of ICE's misreporting, there was an ongoing RER of ICE's market surveillance program. Compliance was engaged in conversations regarding the reporting issues with ODT, Surveillance, and DOE during this time.

Castro Report Recommendation: Compliance leadership should enhance its procedures for selecting DCMs to be reviewed to include the following:

- ***Establish, identify and document selection factors into formalized policy and procedures manual.***
- ***Specify in a procedure manual how the factors gathered for each DCM (trading volume, date of the last RER or other evaluations, etc.) should be analyzed and weighted to determine which DCM will be selected.***
- ***Establish specific trading volumes associated with each Tier classification.***
- ***Specify a period of time in which a DCM should be reviewed at least once. In addition, the policy could be different for each Tier Classification.***

⁴ For example, there have been instances when a newer DCM that was designated using the National Futures Association for regulatory services later decides to perform its own self-regulatory functions. In such instances, DCMs are required to file rule submissions. Market Review and Compliance thoroughly review such filings and require the DCM to demonstrate how it will conduct its regulatory functions and fulfill its regulatory responsibilities.

⁵ The timing of referral and communications with DOE are non-public information.

- ***Work papers should clearly identify the analysis and conclusions reached by Compliance associated with the DCMs selected for review.***

The Division agrees that Compliance should better document its procedures for selecting a DCM for an RER. The Division, however, already has identified and established the selection factors it considers for choosing a particular DCM for an examination. These factors are cited on page 4 of the Castro Report. The Division will establish an RER procedures folder and those factors will be formally documented in that folder. The Division does not believe that each factor should be assigned a specific weight but that senior Compliance staff should have the flexibility to balance the various factors. The Division will document its selection analysis for each RER initiated.

With respect to RER frequency, as noted on page 30 of the FY 2016 President's Budget, the Commission strives for the Division to examine those DCMs deemed most significant on an annual basis (this equates with what the Division deems Tier 1) and the other DCMs every two to three years.⁶ The Division will draft a recommendation within the next 30 days stating the desired frequency of RER for each tier of DCM (recognizing that that this is a goal that will not be met without significant additional resources). This document will be maintained in an RER procedures manual folder. The Division also will establish specific trading volume for each DCM tier classification. Because exchange trading volume changes year-to-year, during the first quarter of every calendar year, the Division will define Tier 1, Tier 2, and Tier 3 based on exchange reported trading volume for the previous year. Once the tiers are defined, the Division will then classify each DCM. This process will be documented and maintained in the electronic RER procedures manual folder.

Finding 3: Follow-Up Procedures on Concerns and Recommendations Made in Prior Rule Enforcement Review Reports Needs to be Enhanced

The Division agrees with the Castro Report's finding that recognizes the value of following-up with a DCM to address recommendations and concerns identified in the Division's RER transmittal letter prior to a subsequent RER. This has always been the Division's practice. The report states, however, that Castro "was not provided any evidence to document any follow-up with the DCM on their corrective plan but we noted that the corrective plan to address these concerns and recommendations are only reviewed during subsequent RERs." The Division disagrees with the assertion that a DCM's corrective action plan is only reviewed during the subsequent RER.

The Division's current practice is to transmit the RER report with a transmittal letter to the DCM at the conclusion of the RER and to require the DCM to respond within 30 days regarding how it intends to address a recommendation for improvement and/or a deficiency. The Division carefully reviews the DCM response and promptly discusses any concerns with the DCM after reviewing the response letter.

⁶ The Division has been unable to meet this goal due to resource limitations. As discussed below in connection with Finding 4, Compliance staff has several other responsibilities in addition to conducting RERs.

While Compliance may not have a fixed timetable for RER follow-up, Compliance staff verbally provided Castro with several examples of the follow-up conducted with DCMs following their response letters and prior to any subsequent RER. For example, in one RER that completed during the Castro Report's review period, the Division found that the DCM did not have an audit trail enforcement program. The DCM provided Compliance with continuous updates (both orally and in writing)⁷ regarding its progress for implementing an appropriate program. Compliance staff worked closely with the DCM to review documents and to provide feedback on new audit trail rules governing the DCM's participants and an updated DCM Compliance Manual. The Division will better document its follow-up process and will maintain the documentation in the appropriate electronic RER folder.

Castro Report Recommendation: Compliance leadership strengthen procedures for following up promptly on all concerns and recommendations issued to a DCM. These procedures should consider, at a minimum, the following:

- ***In consultation with a DCM, establish a time period for the corrective action plans to be implemented.***
- ***Establish scheduling guidelines based on the severity of the concerns and recommendations for Market Compliance Branch follow-up on corrective action plans to determine whether a reviewed DCM has promptly addressed matters identified during the RER.***

The Division's current practice includes direction in its transmittal letter requiring a DCM to respond within 30 days regarding how it will address a recommendation or deficiency. Moving forward, the Division will include language in all transmittal letters that will require the DCM to file a written response to the Division's letter and include a specific timeline in which the DCM plans to address each recommendation or correct any deficiency. The Division will carefully review the DCM's corrective action plan and promptly communicate with the DCM to address any concerns (e.g., the timing for implementing the action plan or the manner in which the DCM intends to address the recommendation or deficiency). The transmittal letter also will require that as soon as practicable after the DCM implements the corrective action plan for a specific recommendation or deficiency, the DCM provide the Division with information sufficient to demonstrate that the action plan has been implemented.

Finding 4: Inadequate Staffing Leads to Lengthy Rule Enforcement Review Completion Time

The Division agrees with the Castro Report's finding that inadequate staffing in Compliance leads to lengthy RER completion times. The Castro Report also correctly identifies "the limited number of full-time employees" within the Compliance Branch as a factor that may impact both the number of RERs conducted and the time necessary to complete an RER. The Division appreciates the Castro Report's willingness to elevate this important issue which significantly

⁷ Compliance can provide Castro with emails evidencing RER follow-up.

limits Compliance's ability to review more DCMs for compliance with more core principles and to do so more quickly.

The Castro Report provides statistics regarding the total number of hours charged to tasks by staff in the Compliance Branch for fiscal years 2011 through 2014. These statistics illustrate the impact of inadequate staffing on Compliance and the RER program; they are certainly below Compliance's potential if it were adequately staffed. As discussed below, Compliance and the RER program were also impacted in fiscal years 2011 through 2014 by the Division's extensive rulemaking and other responsibilities arising from implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").⁸

Fiscal years 2011 through 2013 coincided with significant rulemaking projects undertaken by the Division. Compliance attorneys—who otherwise would have been leading RERs—were primarily devoted in fiscal years 2011 through 2013 to numerous rulemaking projects arising from Dodd-Frank. These included: (1) proposed rules for DCMs published in December 2010; (2) proposed rules for swap data repositories ("SDRs") published in December 2010; (3) proposed rules for swap execution facilities ("SEFs") published in January 2011; (4) final rules for SDRs adopted in September 2011; (5) final rules for DCMs adopted in June 2012; and (6) final rules for DCMs adopted in June 2013. Attorneys in Compliance also contributed to other significant rulemaking projects during this time.

Upon completion of its rulemakings, the Division turned in fiscal year 2014 to temporary and then permanent registration of over two dozen SEFs. Compliance attorneys were heavily involved in such work. Today, in fiscal year 2015, Compliance attorneys continue to spend significant portions of their time implementing the Dodd-Frank Act, including complex reviews to transition SEFs from temporary to permanent registration. The Division anticipates these responsibilities will continue into fiscal year 2016.

Castro Report Recommendation: Compliance leadership should:

- ***Determine whether more staff is needed to timely complete RERs or establish the frequency for conducting RERs with existing staff so as to provide timely results to DCMs.***

Or

- ***Enhance procedures on how RERs are monitored by the Deputy and Associate Directors of Market Compliance Branch by establishing the use of budgets for each RER and/or implementation of strict timeline for the completion of the RER.***

⁸ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010).

- ***Procedures should be enhanced to require DCMs to be more responsive to the Market Compliance Branch's request for information. These and other procedures should be implemented with the purpose of ensuring RERs are completed on a timelier basis.***

The Castro Report's recommendations in this area provide options, including that the Division "determine whether more staff is needed to timely complete RERs...." The Division has long believed that the Compliance Branch does in fact require additional staff and has requested significant additional staff in annual budget request documents. The Dodd-Frank Act, which established SEFs as an entirely new category of self-regulatory organization subject to core principles and numerous regulations, only adds to the urgency of additional Compliance staff. In particular, once all SEFs are permanently registered, there will be more than twice as many entities subject to RERs as there are now, and almost twice as many core principles and regulations. The Division's need for additional staff in the RER program for DCMs alone is already self-evident. With the addition of SEFs, the Division will be unable to perform effective systematic oversight of self-regulatory organizations through RERs.

The Division and its Compliance Branch are committed to fulfilling their oversight responsibilities. Staff will continue its efforts through the RER program to promote market integrity and customer protection to the greatest extent possible under difficult circumstances.