

**RULE ENFORCEMENT REVIEW  
OF THE  
CHICAGO MERCANTILE EXCHANGE  
AND THE  
CHICAGO BOARD OF TRADE**



**Division of Market Oversight  
July 26, 2013**

**RULE ENFORCEMENT REVIEW OF  
THE CHICAGO MERCANTILE EXCHANGE AND  
THE CHICAGO BOARD OF TRADE—MARKET SURVEILLANCE  
Commodity Futures Trading Commission- Division of Market Oversight**

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## I. INTRODUCTION

The Division of Market Oversight (“Division”) has completed a joint rule enforcement review<sup>1</sup> of the market surveillance program of the Chicago Mercantile Exchange (“CME”) and the Chicago Board of Trade (“CBOT”) (collectively, “Exchanges”), wholly-owned subsidiaries of CME Group, Inc. (“CME Group”).<sup>2</sup> The review covered the period from November 1, 2010 to October 31, 2011 (“target period”). Due to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,<sup>3</sup> which became effective during the target period, the Division examined the Exchanges’ compliance with core principles related to market surveillance under Section 5(d) of the Commodity Exchange Act (“CEA”), Core Principles 4 and 5, pre- and post- Dodd-Frank Act. Although the Dodd-Frank Act amended both Core Principles 4 and 5, the Division notes that its recommendations would have been the same whether it

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

The findings and recommendations in this report are limited to CME and CBOT and their respective products, and do not address the market surveillance program at any other CME Group exchange, including the New York Mercantile Exchange (“NYMEX”) or the Commodity Exchange, Inc. (“COMEX”). This report, and the findings and recommendations herein, represent the view of the Division only, and do not necessarily represent the position or view of the Commission or of any other office or division of the Commission.

<sup>2</sup> Chicago Mercantile Exchange Holdings Inc., the parent company of CME, and CBOT Holdings, Inc., the parent company of CBOT, merged in 2007. As a result of this merger, CME and CBOT became wholly-owned subsidiaries of CME Group. Additionally, NYMEX became a wholly-owned subsidiary of CME Group when CME Group purchased it in 2008. As part of the same transaction, CME Group also acquired COMEX, which had operated as a subsidiary of NYMEX since 1994. Each CME Group exchange (CME, CBOT, NYMEX, and COMEX) is separately registered as a designated contract market (“DCM”) under the Commodity Exchange Act.

<sup>3</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010) (“Dodd-Frank Act”). The Dodd-Frank Act’s effective date was July 16, 2011.

evaluated the Exchanges' compliance program under the old or revised core principles for the entire target period.

**Pre-Amendment of the CEA by the Dodd-Frank Act**

**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:**

**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.**

**Post-Amendment of the CEA by the Dodd-Frank Act**

**Core Principle 4 – Prevention of Market Disruption:**

**The board of trade shall have the capacity and responsibility to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process through market surveillance, compliance, and enforcement practices and procedures, including—**

- (A) methods for conducting real-time monitoring of trading; and**
- (B) comprehensive and accurate trade reconstructions.**

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

- (A) In General: To reduce the potential threat of market manipulation or congestion (especially during trading in the delivery month), the board of trade shall adopt for each contract of the board of trade, as is necessary and appropriate, position limitations or position accountability for speculators.**
- (B) Maximum Allowable Position Limitation: For any contract that is subject to a position limitation established by the Commission pursuant to section 4a(a), the board of trade shall set the position limitation of the board of trade at a level not higher than the position limitation established by the Commission.**

During the entirety of the target period, the acceptable practices set forth in Appendix B to Part 38 of the Commission's regulations provided that 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.<sup>4</sup> An exchange also should have routine access to the positions and trading of its market participants. This data should be evaluated on a daily basis to enable the exchange to respond appropriately to potential market disruptions or abusive practices. An effective surveillance program for an exchange with multiple products and a substantial number of traders should include an automated large trader reporting system.

To facilitate orderly liquidation of expiring contracts and diminish expiration problems arising from excessively large positions, an exchange may need to establish position limits for some commodities, although it may substitute position accountability for position limits where the threat of excessive speculation or manipulation is nonexistent or very low. Spot month limits should be adopted for commodities that have more limited deliverable supplies, or where necessary to minimize a market's susceptibility to manipulation or price distortion. Position limits rules may provide for hedge or other exemptions, and may set limits differently by markets, delivery months, or time periods. An exchange should have an effective program for enforcement of position limits, and should monitor the continuing appropriateness of approved exemptions. An exchange should also have an effective program for taking regulatory action when a violation of a position or exemption limit is detected, regardless of whether the violation is by a member or non-member.

For purposes of this review, Division staff interviewed compliance officials and staff from the CME Market Regulation Department ("Market Regulation"), including staff from the Market Surveillance Group ("Market Surveillance"), Investigations Group, and Enforcement

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<sup>4</sup> On May 10, 2012, the Commission issued its Final Rules, *Core Principles and Other Requirements for Designated Contract Markets*, 77 Fed. Reg. 36612 (June 19, 2012), which became effective on October 17, 2012, after the target period. Among other things, this rulemaking revised guidance and acceptable practices for some core principles and, for several core principles such as Core Principles 4 and 5, codified rules in lieu of guidance and acceptable practices. See 77 Fed. Reg. 36,612, 36,614, 36,702-03. Because these rules were not effective during the target period, the Division evaluated the Exchanges' market surveillance program under the pre-existing guidance and acceptable practices.

Group (“Enforcement”). In addition to providing compliance services to CME, Market Regulation is responsible for providing compliance services to CBOT pursuant to a Regulatory Services Agreement between CME and CBOT.<sup>5</sup> The Division also reviewed a demonstration by and numerous documents used by Market Regulation in carrying out the Exchanges’ market surveillance responsibilities. These documents included, among other things, the following:

- a demonstration of the automated surveillance systems used by the Exchanges to conduct market surveillance;
- the Exchanges’ market surveillance procedures manuals and guidelines;
- automated computer reports and other documents generated by the Exchanges’ market surveillance tools;
- files and records concerning stop logic events, settlements at daily price limits, and trade cancellations and price adjustments;
- files and records concerning contract expirations, position accountability and speculative position limit enforcement, and applications for hedge exemptions from position limits;
- files and records concerning market surveillance-related case files and research files; and
- minutes of all target period meetings of the Exchanges’ committees responsible for market surveillance matters.

The Division provided the Exchanges with an opportunity to review and comment on a draft of this report on April 26, 2013. On May 14, 2013, Division staff conducted an exit conference with Market Regulation staff to discuss this report’s findings and recommendations.

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<sup>5</sup> Market Regulation also provides regulatory services to NYMEX and COMEX pursuant to a Regulatory Services Agreement.

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

### **A. Market Regulation Department and Market Surveillance Staff**

#### **Findings**

- Market Surveillance, which is part of Market Regulation, is responsible for carrying out market surveillance for CME and CBOT (as well as NYMEX and COMEX) and contains highly experienced staff.
- As a result of a Market Regulation staffing study conducted after the Division's last joint Rule Enforcement Review of the Exchanges in 2010, Market Surveillance staff increased during the target period from 40 personnel, 22 of whom were primarily dedicated to CME and CBOT, to a total of 45 personnel, 25 of whom were primarily dedicated to CME and CBOT.
- As discussed below in Sections F-H, the Division has concerns and accompanying recommendations relating to the Exchanges' procedures for reviewing hedge exemptions and monitoring Exchange for Related Position ("EFRP") transactions as well as the Exchanges' completion of cases in a timely manner. These recommendations may affect Market Surveillance's staffing needs.

#### **Recommendations**

- The Exchanges should examine their present number of Market Surveillance personnel to ensure that these levels are sufficient to complete cases in a timely manner as well as review hedge exemption applications and monitor EFRPs in a manner consistent with the Division's recommendations in those areas. In addition, the Exchanges should continue to monitor their total trading volume levels, increases to their product lines, and any other factors that could necessitate an increase in staff members to fulfill the Exchanges' self-regulatory responsibilities related to market surveillance.

### **B. Market Surveillance Systems**

#### **Findings**

- Market Surveillance's principal tool for monitoring trading is the Large Trader Reporting System ("LTRS"), which has recently been enhanced with a number of new and upgraded automated surveillance tools. Market Surveillance supplements its surveillance capabilities with several other systems, such as the

Sophisticated Market Analysis Research Technology (“SMART”) tool, the Exchanges’ primary trade practice surveillance application, and the Regulatory Application for Processing In-Memory Data (“RAPID”) tool, which captures all order, trade, and market data messaging information on a real-time basis.

**Recommendations**

- The Division has no recommendations in this area.

**C. Routine Surveillance of Market Fundamentals**

**Findings**

- Market Surveillance conducts daily review of the trading and positions of large traders, monitors market factors that could affect orderly liquidation, and analyzes atypical price, spread, and basis relationships and other unusual market circumstances that could raise the potential for a liquidation problem. Market Surveillance also maintains frequent contact with market participants.

**Recommendations**

- The Division has no recommendations in this area.

**D. Surveillance of Expiring Contracts**

**Findings**

- Market Surveillance heightens surveillance of expiring contracts to detect and prevent price manipulations and facilitate orderly liquidations, focusing on position concentrations, large trader positions, and the relationship between deliverable supply and open interest.
- Market Surveillance identified six contract expirations that required particular scrutiny during the target period. All six expiration files were well-documented. For each of the six non-routine expirations, Market Surveillance tailored its approach differently and appropriately, resulting in early detection of potential problems and responsive steps by staff. All six contract expirations culminated in an orderly fashion.

**Recommendations**

- The Division has no recommendations in this area.

## **E. Position Accountability Levels and Speculative Position Limits**

### **Findings**

- The Exchanges monitor the size of participants' positions via position accountability levels and to enforce speculative position limits.
- During the target period, the Exchanges' position limit research and case files were typically well-documented, including Investigation Reports, which described the details surrounding the investigations. Some files additionally contained brief close-out memoranda that summarized the investigation and conclusion. However, nearly every Investigation Report reviewed by the Division did not contain signatures by either the surveillance analyst or senior staff member reviewing the matter, and almost all of the close-out memoranda the Division reviewed contained an inaccurate date field designed to auto-update whenever the file is opened. (The Division notes that these control issues were present across all matter types (i.e., position limit, EFRP, and miscellaneous) it reviewed.)
- The Exchanges issued fines for three speculative limit cases that were closed during the target period, and all were justified by the facts of each case. However, the Division identified one case where a market participant exceeded a position limit and failed to file a retroactive hedge exemption application until the seventh business day after assuming the relevant position. Though the Exchanges' rules permit a participant to file a retroactive hedge exemption application, to avoid a position limit violation, within one business day after assuming the position except in circumstances where Market Regulation has expressly approved a later filing which may not exceed five business days, Market Surveillance nevertheless approved the untimely application and did not treat the matter as a position limit violation.
- In addition, the Division identified one case, in which the market participant continued to increase its position despite notification of a position limit violation, where Market Surveillance properly found the conduct to be "egregious" but only issued a warning letter instead of using its discretion to refer the matter to Enforcement.
- While the Exchanges resolved the majority of the position limit matters in a timely manner, nine cases were closed during the target period that had been open for over 12 months. In the majority of these nine cases, Market Regulation

explained that the delays in resolution were due to the process of changing from an automatic fine structure for position limit violations to a more flexible sanctioning approach that considered a variety of factors on a case-by-case basis and required the calculation and disgorgement of profits related to the overage.

### **Recommendations**

- The Exchanges should ensure that, for all research and case files, Investigation Reports contain signatures by the relevant personnel and close-out memoranda contain accurate dates.
- The Exchanges should not grant a retroactive hedge exemption if a participant does not file a timely application within the timeframe provided in the Exchanges' rules. If a market participant fails to submit a timely retroactive hedge exemption application, the speculative limit violation should be treated as a violation of the Exchanges' speculative limit rules.
- Market Surveillance should utilize its discretion to refer matters to Enforcement for the prospect of meaningful sanctions and to deter participants from committing egregious conduct, such as continuing to increase positions after notification by Market Surveillance of position limit violations.
- The Exchanges should not implement any new rule or process until they first take appropriate measures to ensure that they can effectively and promptly implement the rule or process without delaying the resolution of affected cases for a prolonged amount of time.

## **F. Hedge Exemptions from Position Limits**

### **Findings**

- The Exchanges' rules allow market participants to apply for hedge exemptions from position limits where they hold bona fide hedge positions, risk management positions, or arbitrage/spread positions.
- The Division believes that Market Surveillance's hedge exemption procedures could be more robust by administering certain changes. In reviewing representative hedge exemption files across all of the Exchanges' product markets, the Division found that the files included the subject application, work papers, and an approval letter. However, the Division found that several of the applications were incomplete and that several applicants received exemptions for hedging categories different from those requested. In addition, the Division is

concerned that Market Surveillance granted exemption levels for 12 participants in excess of the levels the participants had requested.

### **Recommendations**

- Market Surveillance should ensure that, prior to granting a hedge exemption, the applicant has submitted a complete and accurate application and has designated the appropriate hedging category(ies).
- Market Surveillance should monitor its hedge exemption program to ensure that its procedures prevent an exemption from being granted at a level above that requested by an applicant.

## **G. Monitoring of EFRPs**

### **Findings**

- The Exchanges' rules allow for Exchange for Physicals ("EFPs"), Exchange for Risk ("EFRs"), and Exchange for Options ("EOOs") transactions and, among other things, hold clearing firms responsible for exercising due diligence as to the bona fide nature of EFRP transactions.
- Market Surveillance analysts monitor EFRPs via the Market Review of Ex-Pit Data ("MRED") application within the SMART system. However, the Exchanges only open case files for EFRPs that indicate potential Exchange rule violations. EFRP documentation is only requested for those transactions that are the subject of a case. Documentation is not requested when EFRPs are simply monitored via MRED.
- During the target period, the Exchanges closed 13 EFRP cases and opened 16 EFRP cases. The Division found that the 13 closed cases were completed in a timely manner and well-documented.
- The Division is concerned that, during the target period, Market Surveillance's MRED queries and other analyses triggered the opening of only 16 EFRP cases, as compared to the 484,218 total EFRPs transacted on the Exchanges during the period.
- The Division found that the Exchanges have an inadequate program for ensuring that parties to an EFRP transaction maintain relevant documents pursuant to the Exchanges' documentation requirements and, accordingly, for verifying the bona fides of a sufficiently large, strategically selected sample of EFRPs. An improved

and robust program is necessary both to uncover non-bona fide EFRPs as well as to deter parties from entering into and clearing firms from processing non-bona fide EFRPs. During the target period, the Exchanges did not sample any other EFRPs, outside of the 16 EFRPs resulting in cases, to verify their compliance with their documentation requirements and, accordingly, verify their bona fides.

### **Recommendations**

- Market Surveillance should ensure that the factors and procedures it uses to identify EFRPs that warrant the opening of case files are adequately targeting problematic EFRPs.
- Market Surveillance should establish an adequate and robust program to ensure that parties and clearing firms to EFRP transactions maintain relevant documents pursuant to the Exchanges' rules and, accordingly, verify the bona fides of a sufficiently large, strategically selected sample of EFRPs. Specifically, the Exchanges should subject all clearing firms that clear EFRPs to a strict audit process whereby the Exchanges:
  1. Request documentation for (including all documents relevant to the Exchange contract and the cash, OTC swap, or other OTC derivatives) and verify the bona fides of multiple EFRP transactions (including EFPs, EFRs, and EOOs) across every product category at least once every calendar year;
  2. Strategically select the EFRPs for review with an eye to detecting misconduct; and
  3. Subject any clearing firm and parties to a violative EFRP to heightened scrutiny, including analyses of past EFRPs and future EFRPs.

## **H. Miscellaneous Research and Case Files Reviewed by the Division**

### **Findings**

- During the target period, in addition to the position accountability, position limit, and EFRP matters, Market Surveillance opened and closed research and case files relating to other miscellaneous violations such as delivery, disruptive trading, manipulation, excessive bids/offers, aggregation, large trader reporting, open interest reporting, regularity reporting, and non-competitive trading.

- Two of the closed matters resulted in warning letters, and both were justified by the facts of each case. Market Surveillance's files for all of the closed cases were well-documented.
- Of the closed matters, two remained open longer than 12 months without any apparent extenuating circumstances. In addition, nine cases were opened prior to the target period and were closed after the target period or are still open. The majority of these matters remained or have remained open for over 12 months without any mitigating circumstances and feature instances where there were prolonged periods of inactivity, internal activity logs were not kept up to date, and investigations were completed yet administrative closure was delayed.

### **Recommendations**

- The Exchanges should ensure that all research and case files are closed within 12 months of the date they are opened, absent extenuating circumstances, and that all research and case files contain orderly documentation, including up-to-date activity logs.

### III. PRODUCTS AND TRADING VOLUME DURING THE TARGET PERIOD<sup>6</sup>

Total trading volume at CME and CBOT during the target period was 1,831,478,286 and 1,060,784,945 contracts, respectively. CME offered 129 different products and corresponding options for trading during the target period, but four products accounted for over 80 percent of total volume: Three-Month Eurodollar futures accounted for 38 percent; E-Mini S&P 500 Stock Index futures accounted for 35 percent; Euro futures accounted for five percent; and NASDAQ-100 Stock Index (Mini) futures accounted for four percent. CBOT offered 37 different products and corresponding options for trading during the target period, while five products accounted for over 80 percent of total volume: 10-Year U.S. Treasury Notes futures accounted for 36 percent; Five-Year U.S. Treasury Notes futures accounted for 17 percent; 30-Year U.S. Treasury Bonds futures accounted for 10 percent; Corn futures accounted for 10 percent; and Two-Year U.S. Treasury Notes futures accounted for seven percent. Additional trading volume, product line, electronic versus open outcry trading, and EFRP information is provided in Figures 1 to 3 and Table 1 below.

Figure 1 below compares the total trading volume at the Exchanges during the target period with the total trading volume from the target period for the Division's last Rule Enforcement Review of the Exchanges (January 1, 2008 to January 1, 2009).<sup>7</sup> As shown below,

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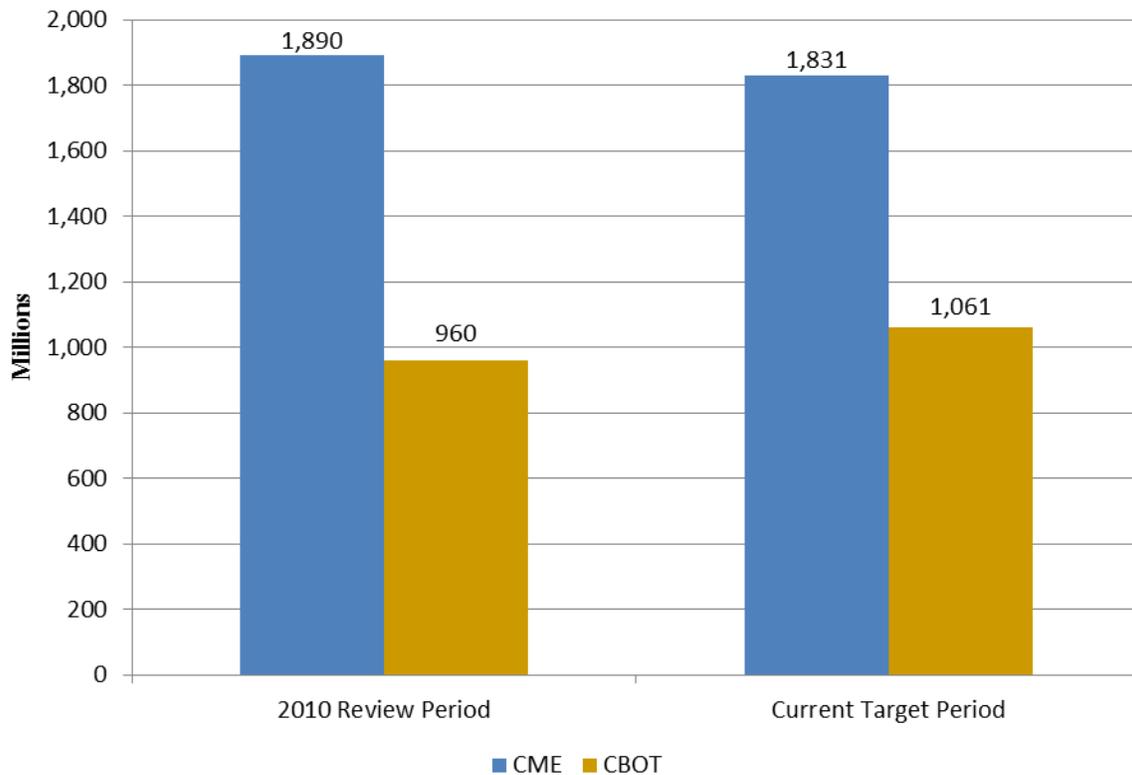
<sup>6</sup> Data used in this Section was obtained from the Exchanges.

<sup>7</sup> While this is the Division's first Rule Enforcement Review of CME and CBOT's market surveillance programs since the merger between CME and CBOT, the Division issued a joint Rule Enforcement Review on September 13, 2010 that examined the Exchanges' compliance with core principles relating to their audit trail, trade practice surveillance, and disciplinary programs. See CFTC, Div. of Mkt. Oversight, Rule Enforcement Review of the Chicago Board of Trade and the Chicago Mercantile Exchange (Sept. 13, 2010) ("2010 Review"), available at [http://www.cftc.gov/ucm/groups/public/@iodcms/documents/file/rercbot\\_cme091310.pdf](http://www.cftc.gov/ucm/groups/public/@iodcms/documents/file/rercbot_cme091310.pdf).

The Division's last Rule Enforcement Reviews of CME and CBOT's individual market surveillance programs occurred in 2003 and 2007, respectively.

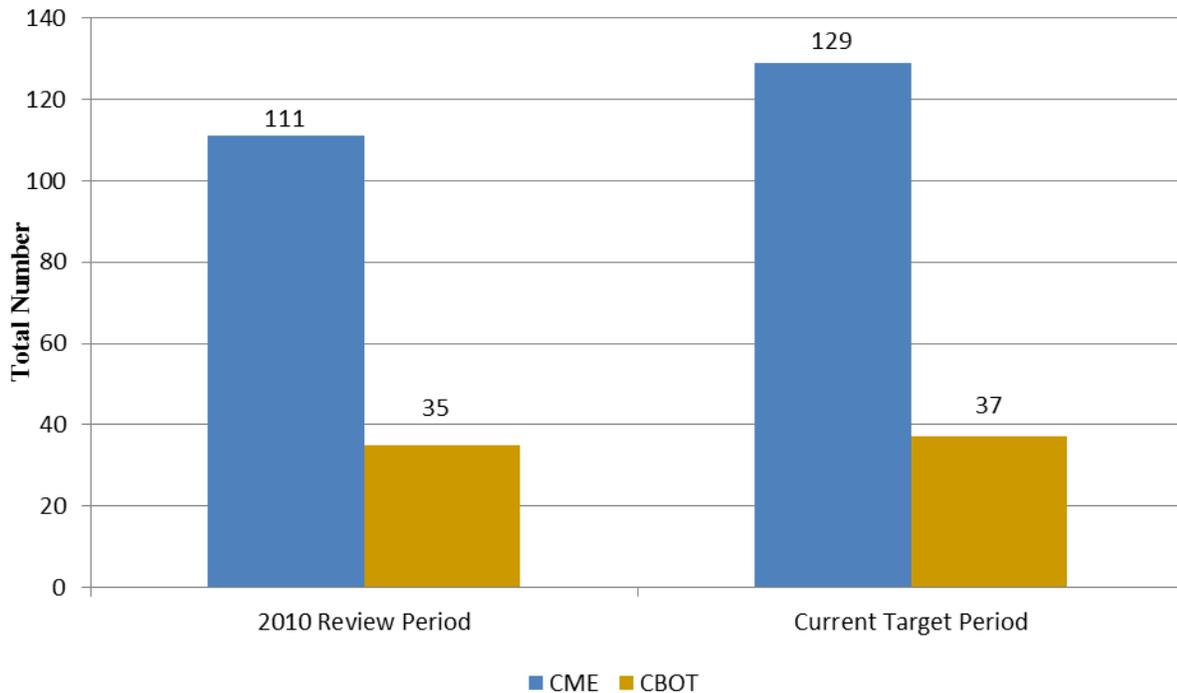
from the 2010 Review’s target period to the current target period, total trading volume at the Exchanges has remained relatively constant (from a total of 1,890,492,555 to 1,831,478,286 contracts for CME and from a total of 960,446,329 to 1,060,784,945 contracts for CBOT).

**Figure 1 – Total Volume during Target Period and the 2010 Review Period**



At the same time, CME and CBOT’s product line increased by approximately 16 percent and six percent, respectively, as depicted in Figure 2 below.

**Figure 2 – Number of Products Offered for Trading**



In addition, CME and CBOT listed for trading several significant, new products during the target period. In December 2010, CME listed for trading new Two- and Three-Year Eurodollar Mid-Curve options and three new E-micro Forex futures, and in March 2011, listed new E-Mini S&P 500 Sector Index futures for a variety of industry sectors. In January 2011, CBOT listed for trading new Weekly Treasury options and, in May 2011, introduced new Weekly Grain options. Since these launches, over seven-and-a-half million Three-Year Eurodollar Mid-Curve options contracts have traded on CME and over two million Weekly Treasury options contracts have traded on CBOT.

Figure 3 below shows the percentages of electronic and open outcry trading at CME and CBOT, respectively.<sup>8</sup> As shown, the percentage of trading conducted electronically at CME has increased from the 2010 Review (from 84 to 88 percent), while the percentage of open outcry trading has declined (from 16 to 12 percent). Likewise, the percentage of electronic trading at CBOT has increased (from 80 to 88 percent), while the percentage of open outcry trading has declined (from 20 to 12 percent). Open outcry remains the preferred method of trading most options at both Exchanges.

**Figure 3 – Continued Growth of Electronic Trading Between Target Periods**

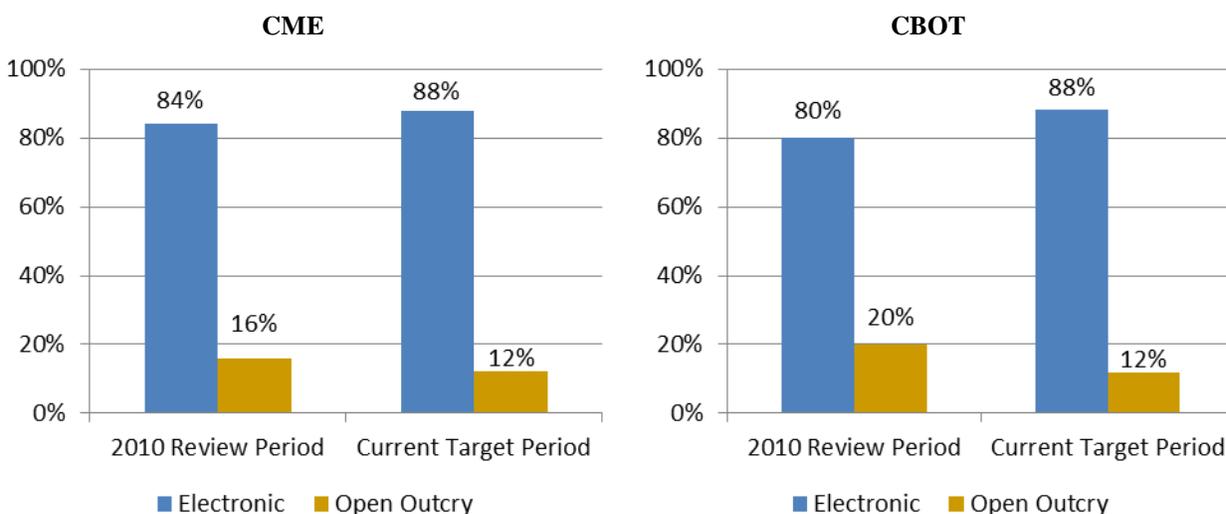


Table 1 below shows the total number of EFRPs (broken down by Exchange for Physicals (“EFPs”), Exchange for Risk (“EFRs”), Exchange for Swaps (“EFSs”), and Exchange of Option for Options (“EOOs”)) at CME and CBOT during the target period and the 2010 Review period. Both Exchanges, especially CME, have experienced growth in all types of EFRPs.<sup>9</sup>

<sup>8</sup> In calculating the percentages, volume arising from privately negotiated transactions (e.g., EFRPs and block trades) has been excluded.

<sup>9</sup> Effective October 31, 2010, pursuant to CME Rule 538 (Exchange for Related Positions), CME removed the EFS identifier for all CME exchange futures with the EFS transaction type being harmonized and subsequently falling

**Table 1 – Total EFRP Transactions**

<b>CME</b>	<b>Total EFRPs</b>	<b>EFPs</b>	<b>EFRs</b>	<b>EFSs/EOOs<sup>10</sup></b>
2010 Review Period	153,339	153,115	224	0
Target Period	317,799	316,026	1,670	103
<b>CBOT</b>	<b>Total EFRPs</b>	<b>EFPs</b>	<b>EFRs</b>	<b>EFSs/EOOs</b>
2010 Review Period	152,778	142,625	7,350	2,803
Target Period	166,419	148,290	11,268	6,861

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under the EFR transaction type. See CME Group, Advisory Notice, Harmonization of EFRPs in Clearing for CME Exchange Products Only, available at <http://www.cmegroup.com/tools-information/lookups/advisories/clearing/files/Chadv10-433.pdf>. Likewise, after the target period had concluded, effective July 1, 2012, CBOT removed the EFS identifier for all CBOT exchange futures with the EFS transaction type being harmonized and subsequently falling under the EFR transactions type. See CME Group, Advisory Notice, Harmonization of EFRPs in Clearing for CBOT Exchange Products Only (June 13, 2012), available at <http://www.cmegroup.com/tools-information/lookups/advisories/clearing/Chadv12-246.html#UHgyfIgub60.email>.

<sup>10</sup> EFSs and EOs are combined because EOs did not begin to be transacted on CBOT until October 2009.

#### IV. MARKET SURVEILLANCE PROGRAM

##### A. Market Regulation Department and Market Surveillance Staff

###### 1. Overview of the Market Regulation Department

With the CME, CBOT, NYMEX, and COMEX mergers, the CME Group now has one Market Regulation Department, which performs compliance functions for all four of the CME Group exchanges. At the beginning of the target period, November 2010, Market Regulation consisted of 140 fully dedicated staffed personnel.<sup>11</sup> Of the 140 positions, 101 were based in Chicago and assigned to carry out the self-regulatory obligations for CME and CBOT, although Market Regulation staff may have compliance responsibilities that span multiple exchanges. Today, Market Regulation is led by CME Group's experienced management team, including a Corporate Counsel and Corporate Secretary (nine years of exchange experience), a Chief Regulatory Officer (26 years of exchange experience), and a Deputy Chief Regulatory Officer (24 years of exchange experience).

Market Regulation houses several sub-groups, including Market Surveillance, the Investigations Group, Enforcement, and the Strategic and Technology Initiatives Group:<sup>12</sup> (i) Market Surveillance is responsible for carrying out the market surveillance functions for all four CME Group exchanges (discussed in greater detail *infra* next Section); (ii) the Investigations

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<sup>11</sup> At the conclusion of the 2010 Review period (and after consolidation of the CME and CBOT compliance staffs in the spring of 2008), Market Regulation had a 93-person compliance staff. *See* 2010 Review, *supra* note 7, at 10. Although the growth to 140 people was primarily due to the 2008 mergers with NYMEX and COMEX, 17 of the 47 positions were new positions added in 2009 and 2010.

<sup>12</sup> The senior management team for these Groups includes the Director of Global Market Surveillance (26 years of exchange experience), the Director of Global Market Investigations (26 years of industry-related experience), the Global Enforcement Counsel (four years of exchange experience and eight additional years of industry-related experience), and the Director of Global Market Regulatory Strategy and Technology (33 years of exchange experience).

Group is responsible for investigating potential violations, including market surveillance violations; (iii) Enforcement is responsible for prosecuting disciplinary cases; and (iv) the Strategic and Technology Initiatives Group is responsible for coordinating the development of CME Group's regulatory systems and addressing regulatory considerations with respect to strategic initiatives and new product launches.<sup>13</sup>

In the 2010 Review, the Division expressed concern that Market Regulation's staffing levels during the 2010 Review's target period had been reduced despite significant increases in average monthly trading volume and the number of products traded. Adequate staffing of compliance responsibilities at the four CME Group exchanges is of particular concern because of the substantial share of the entire U.S. futures and options marketplace accounted for by the CME Group exchanges. Therefore, the Division recommended that CME Group undertake a comprehensive review of the compliance staff size needed to ensure that the compliance services provided to all CME Group exchanges by Market Regulation remain effective in enforcing compliance with all exchange rules and Commission regulations. In response to the Division's recommendation, Market Regulation conducted a staffing study and recommended to CME Group's Market Regulation Oversight Committee ("MROC")<sup>14</sup> that 11 new Market Regulation positions be added in 2011. The study was reviewed by the MROC, which concurred with the recommendations, and senior management at CME Group approved 11 new positions. The Division was pleased to learn that, during the target period, the Exchanges followed the MROC

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<sup>13</sup> Market Regulation also includes the Employee Development Initiatives Group, which is responsible for employee training and continuing education.

<sup>14</sup> As stated in its charter, the MROC is a committee of CME Group Directors charged with providing "independent oversight of the policies and programs" of Market Regulation, in order to "enable [Market Regulation] to administer effectively the self-regulatory responsibilities of" CME Group and its exchanges. These responsibilities include, among other things, reviewing and making recommendations with respect to Market Regulation's "responsibilities, budget and staffing," and conducting oversight of Market Regulation's performance of its responsibilities.

recommendations and added 11 positions, including five for Market Surveillance (three in Chicago and two in New York), four for the Investigations Group (two in Chicago and two in New York), and two for Enforcement (both in Chicago). Accordingly, at the end of the target period, October 2011, Market Regulation had increased from 140 to 151 staff members, 108 of whom were primarily dedicated to CME and CBOT.<sup>15</sup>

## 2. Market Surveillance Staff

At the beginning of the target period, November 2010, Market Surveillance consisted of 40 total staff members, 22 of whom were based in Chicago and dedicated primarily to carrying out the self-regulatory obligations for CME and CBOT.<sup>16</sup> Market Surveillance is presently headed by a Global Director of Surveillance, who reports to Market Regulation's Deputy Chief Regulatory Officer, and ultimately to Market Regulation's Chief Regulatory Officer. The Global Director's direct reports include two Senior Directors based in Chicago (collectively almost 40 years of futures experience) who are primarily responsible for Market Surveillance's regulatory responsibilities with respect to CME and CBOT, as well as maintaining some cross-regional responsibilities concerning NYMEX and COMEX.<sup>17</sup>

The two Senior Directors each oversee two Managers who themselves supervise analyst teams dedicated to different tasks. The first Senior Director oversees one Manager who supervises the Large Trader Group and one Manager who supervises a team of contract

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<sup>15</sup> During this review, Market Regulation advised the Division that following its 2012 staffing study, the total number of staff members approved for 2013 increased to 160.

<sup>16</sup> Following the merger of CME and CBOT in 2007 to the beginning of the target period, the total number of Market Surveillance staff doubled from 20 to 40 staff members due to the mergers with NYMEX and COMEX and the addition of four new positions in 2009 and 2010.

<sup>17</sup> Also reporting to the Director of Global Market Surveillance is a Director based in New York (six years of industry experience) who oversees the New York office's market surveillance functions related to NYMEX and COMEX and does not have cross-regional responsibilities with respect to CME and CBOT.

surveillance analysts. The four-person Large Trader Group, among other things, provides front-line analysis of any potential speculative position limit concerns (discussed in more detail *infra* Section IV.E.2), and divides its four-person staff equally across Chicago and New York. The Large Trader Group utilizes a reporting structure whereby personnel across Chicago and New York report to one Manager in Chicago to harmonize the resolution of any Large Trader reporting problems, as such problems usually occur across the CME Group's various DCMs. The five-person team of surveillance analysts under this Senior Director is responsible for surveillance of the dairy markets, equity indexes, corn, oats, distillers' dried grain, lean hogs, lumber, and wood pulp futures and options contracts.

The second Senior Director oversees one Manager who supervises the Registrar's Office and one Manager who supervises a second team of contract surveillance analysts. The four-person Registrar's Office (which is part of Market Surveillance at CME Group) is responsible for, among other things, processing applications for any facilities, vaults, or other entities that apply to be eligible as delivery locations for a specific product, and operates across all of the CME Group's DCMs. The five-person team of surveillance analysts under this Senior Director is responsible for monitoring physically delivered agricultural products and currency products, providing front-line analysis of EFRP transactions, and reviewing hedge exemption applications (discussed in more detail *infra* Sections IV.F.1 & IV.G.2).

Each contract surveillance analyst is assigned primary market surveillance responsibility for, on average, either two or three core Exchange products.<sup>18</sup> In addition, the Exchanges work towards cross-pollinating analysts across product markets such that all surveillance analysts

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<sup>18</sup> By core product, this means that the analyst who, for example, covers Treasury contracts will also cover all contracts that aggregate into it. For some products, where there is de minimis trading, Market Surveillance will only assign an analyst if volume increases during a particular period.

develop an understanding of markets outside their areas of direct coverage. To this end, Market Surveillance analysts work closely with other analysts who are assigned to different but correlated products (i.e., analysts covering CME agricultural products with analysts covering CBOT grain products). This, in essence, creates back-up surveillance coverage for all of the Exchanges' products.

As discussed in greater detail in Section IV.C, surveillance analysts conduct daily monitoring of futures and cash prices, market news, volume, open interest, deliverable supply, and data on available supply and demand relating to each contract. The procedures that analysts follow are detailed in a general Market Surveillance Operational Overview Manual as well as more specifically in separate manuals dedicated to Large Trader reporting, Registrar's Office procedures, hedge exemption applications, investigations, position accountability, and position limits. Each analyst's daily routine for surveillance of his or her assigned contracts includes comprehensive review of market data, clearing member and large trader positions, the previous trading day's price performance, industry statistics on cash and futures prices and supply/demand fundamentals, and general market research. Data concerning electronic trades executed on Globex is available to Market Surveillance analysts in the same manner as open outcry data, and analysts follow the same procedures for reviewing both electronic and open outcry trading.

During the target period and in response to Market Regulation's staffing study conducted after the 2010 Review, Market Surveillance increased its staff from 40 personnel, 22 of whom were primarily dedicated to CME and CBOT, to 45 personnel, 25 of whom were primarily dedicated to CME and CBOT.<sup>19</sup> At the same time, CME's average monthly trading volume was

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<sup>19</sup> As of May 2012, after the target period had ended, the total number of Market Surveillance personnel remained at 45; however, 27 staff members were dedicated to CME and CBOT. Following Market Regulation's 2012 staffing study, six additional Market Surveillance positions were approved in January 2013, including three positions dedicated to CME and CBOT and three positions dedicated to NYMEX and COMEX, bringing the total Market

approximately 153 million contracts per month during the target period as compared to approximately 158 million contracts during the 2010 Review period; CBOT's average monthly trading volume was approximately 88 million contracts per month during the target period as compared to approximately 80 million contracts during the 2010 Review period. Accordingly, since the 2010 Review period, the Exchanges' trading volume has remained relatively constant, albeit with month-to-month fluctuations.

### **Recommendations with Respect to Market Surveillance Staff**

CME Group's Market Regulation Department houses a Market Surveillance Group with highly experienced staff. Although the Division generally believes that the number of Market Surveillance staff assigned to CME and CBOT was sufficient during the target period, the Division is concerned about whether the Exchanges' staffing levels as of the conclusion of the target period are sufficient to implement the Division's recommendations made in this report with respect to reviewing hedge exemption applications, monitoring EFRP transactions, and closing cases in a timely manner<sup>20</sup> without impacting the remainder of the Exchanges' market surveillance program. Accordingly, the Division recommends that:

- **The Exchanges examine their present number of Market Surveillance personnel to ensure that these levels are sufficient to complete cases in a timely manner as well as review hedge exemption applications and monitor EFRPs in a manner consistent with the Division's recommendations in those areas. In addition, the Exchanges should continue to monitor their total trading volume levels, increases to their product lines, and any other factors that could necessitate an increase in staff members to fulfill the Exchanges' self-regulatory responsibilities related to market surveillance.**

#### **B. Market Surveillance Systems**

Since the CME, CBOT, NYMEX, and COMEX mergers, CME Group has strived to take the best aspects of each DCM's large trader system and consolidate them into one Large Trader

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Surveillance staff to 51. In addition, after the target period, Market Surveillance informed the Division that it had established a new Specialist role with responsibilities that include establishing and implementing enhanced internal case management and quality controls. This new hire reports directly to the Global Director of Surveillance.

<sup>20</sup> See *infra* Sections IV.F-H.

Reporting System (“LTRS”) that operates for all the exchanges. In addition, CME Group has implemented new market surveillance tools and enhanced existing systems to add increased functionality. The Exchanges’ core market surveillance tool remains the LTRS, though CME and CBOT complement the LTRS with additional, sophisticated tools that are described below.

1. Large Trader Reporting System

The LTRS is Market Surveillance’s principal tool for monitoring trading on the Exchanges’ various markets. The system contains data showing the positions held on the Exchanges by all reportable traders, as that term is defined by Commission regulations and CME and CBOT rules, for each trading day from 2004 to the present for CME and 2006 to the present for CBOT. The Exchanges require all clearing members, FCMs, and foreign brokers to provide close-of-business position data for all reportable traders to Market Surveillance by 8:00 a.m. the following business day.<sup>21</sup> Virtually all of this data is transmitted directly to the LTRS by electronic data feed. The LTRS also receives the details of each cleared trade through a feed from the Exchanges’ clearing system.

The LTRS database also includes all information contained in the copies of CFTC Form 102 (“Identification of Special Accounts”) filed with the Exchanges. CME and CBOT require clearing members, omnibus accounts, and foreign brokers to identify each account that exceeds reportable levels by filing a Form 102 for that account with Market Surveillance within one business day of the account becoming reportable.<sup>22</sup> In addition, clearing members, omnibus accounts, and foreign brokers must submit revised forms within three business days of any

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<sup>21</sup> CME and CBOT Rule 561 (Reports of Large Positions).

<sup>22</sup> CME and CBOT Rule 561. Form 102 is designed to comply with the provisions of Commission Regulation 17.01(b).

material change to the information previously provided.<sup>23</sup> The form provides information on the account's ownership and control, and identifies futures and options traders who trade for the account.

Market Surveillance assigns a unique LTRS identification number to each trader who becomes reportable. The LTRS uses this identification number to aggregate the trader's positions across different accounts at multiple clearing members. Market Surveillance also assigns a group identification number to entities that are affiliated, and the LTRS uses this number to aggregate the positions of all related affiliates.

Since the merger between CME and CBOT, the Exchanges have added a number of new electronic surveillance tools and enhanced the LTRS, which improves Market Surveillance's monitoring across all of its markets. Recently, the Exchanges have introduced a new LTRS interface that enables Market Surveillance analysts to view a wide range of metrics related to their product markets, as well as to customize their platforms to view information and alerts most relevant to them. Use of these tools in combination with traditional market surveillance techniques increases Market Surveillance staff members' efficiency.

First, the LTRS features an improved position detail screen that displays trader positions and allows for significantly increased customization by Market Surveillance analysts. While still presenting the positions reported by all reportable traders on a daily basis, this screen now enables analysts to configure how they view their products on an individualized basis, allowing analysts to format how their reports look and what information they contain. For example, Market Surveillance analysts can view, chart, and graph single products or aggregate similar products, adjust date and time frame settings, select the exchange(s) from which to draw data,

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<sup>23</sup> CME and CBOT Rule 561.

and export position data to external sources, among other functionalities. This increased flexibility allows analysts to design the reports that will best assist them in monitoring their markets quickly and efficiently.<sup>24</sup>

Second, the LTRS has a new alerts and notifications functionality that provides critical information to Market Surveillance analysts immediately upon log in. Market Surveillance analysts may access custom information relevant to their products and have it automatically presented as one of these alerts. These alerts may consist of lifecycle alerts (i.e., a notification x days before a contract's last trading day), historical alerts (i.e., a snapshot of all alerts generated over the past x days), or alerts based on volume and open interest anomalies. For any alert, the Market Surveillance analyst can quickly access volume and open interest metrics in the particular product, as well as the Over-the-Limit ("OTL") Report. The OTL Report provides both end-of-day positions and identifies where market participants have exceeded the position limits for particular products as well as identifies situations where a participant exceeds intraday limits.<sup>25</sup>

Third, the LTRS generates the following reports to identify trading that may merit additional scrutiny by analysts: (i) Volume and Open Interest Reports show open interest and volume and include customizable graphing capabilities; (ii) Reference Reports allow analysts to look at position accounts and trading accounts, aggregation relationships, market participant IDs, and Exchange Index Numbers ("EINs")<sup>26</sup>; (iii) Position Accountability Reports identify where

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<sup>24</sup> While Market Surveillance analysts have significant flexibility in customizing reports for their markets, including the information the reports contain and the frequency of their generation, some reports, such as Position Accountability and Position Limit Reports, contain specific, unchangeable information and are generated at set times.

<sup>25</sup> See *infra* Section IV.E.2 for further discussion of the OTL Report and position limit monitoring.

<sup>26</sup> The Exchanges utilize unique EINs to group together related market participants for aggregation purposes.

participants have exceeded the Exchanges' position accountability levels for a given product; (iv) Hedge Exemption Reports list all hedge exemptions on file and are generated and sent to the Commission on a monthly basis; and (v) Misreporting Reports compare a market participant's large trader position with its reported open interest on the long and short side of the market to identify potential misreporting violations involving open interest or large trader positions.

Each analyst conducts daily—and usually several times a day—review of the various LTRS reports concerning the contracts for which he or she is responsible. To enhance detection of potential position reporting problems, analysts work closely with their direct Managers and meet with him or her whenever a potential issue arises for the analysts' assigned contracts.

## 2. Other Market Surveillance Systems

Market Surveillance complements the LTRS with several other systems that assist surveillance analysts in their daily functions. First, the Sophisticated Market Analysis Research Technology (“SMART”) tool serves as the primary trade practice surveillance application for Market Regulation, although the tool is also useful for conducting market surveillance.<sup>27</sup>

SMART is a non-Web based application that receives and maintains all cleared trade and quotation data for both the electronic and open outcry venues at the Exchanges, as well as reference data that matches market participant information, names, and Tag 50 IDs<sup>28</sup> with accounts in the LTRS. SMART allows surveillance analysts (and investigators) to easily create trading profiles for accounts, traders or firms, and profiles of normal activity for particular markets. From these profiles, analysts can identify any deviations from normal activity. Market

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<sup>27</sup> Prior to the CME and CBOT merger, each Exchange had legacy tools similar to SMART, which were subsequently folded into the SMART system that the Exchanges currently use.

<sup>28</sup> Exchange rules require that each order entered into CME Globex include the submission of a “Tag 50 ID,” which is a user ID assigned to him or her by the Exchange, a clearing member, or other authorized entity. *See* CME and CBOT Rule 536.B (Globex Order Entry).

profiles also can be used to identify periods when particular market conditions existed (e.g., uptrends or downtrends, rallies, declines, and fast markets) and to examine particular trader activity during such conditions. For example, a “volumetric” profile allows analysts to examine trade data from four different perspectives: by market participant, firm, Tag 50 ID, and open outcry traders.

Second, the Regulatory Application for Processing In-Memory Data (“RAPID”) tool captures all order, trade, and market data messaging information directly from the CME Globex trading engine on a real-time basis and stores it online. RAPID thereby enables an analyst to view, analyze, summarize, and reconstruct Globex trading activity, as well as create customizable reports relevant to the analyst’s products. The Armada application allows staff to view the three to 10-deep published order book in any Globex product in real-time or historically, and a new functionality, Armada Cruiser, allows staff to replay the market at varying speeds. Third, E-Quotes is a quotes and news tool vended by the CME Group that provides live and historical prices, charts, news, and analytics. It enables analysts to monitor markets in real-time from a price movement perspective whereby they can determine trends and set up alerts for various price movements. Fourth, the Live Alerts tool “listens” live to the Globex trading engine and analyzes matched traded activity for every active market participant/account in real-time, generating alerts for any instances where an account either deviates from its established volume or position averages or exceeds defined product-specific thresholds for position or volume. Fifth, the Registrar Reporting tool allows for the online reporting of receipts, shipments, and inventories of grains by regular warehouses and facilities and provides registrar staff with the ability to identify and resolve any out-of-reconciliation reporting quickly. Sixth, the Market Alert Surveillance System (“MASS”) tool, developed by

the GCC, analyzes live Globex market data to assist in the proactive identification of market volume and price events.

The Division believes that the LTRS and Market Surveillance's additional tools are sufficient to assist staff in monitoring trading on the Exchanges' various markets. Accordingly, the Division has no recommendations in this area.

### **C. Routine Surveillance of Market Fundamentals**

#### **1. Prices, Volume, and Open Interest**

Each Market Surveillance analyst is responsible for monitoring market developments, changes in both futures and cash prices, and spread relationships in each of his or her assigned markets. Analysts use several tools for these purposes. Staff utilizes E-Quotes (discussed *supra* p. 28) for live and historical prices, charts, news, and analytics. E-Quotes enables analysts to monitor markets in real-time from a price movement perspective and to determine trends and set up alerts for various price movements. In addition, staff consults the Bloomberg News Service, which provides real-time news and cash market prices, and the ability to chart historical price relationships for various markets. Analysts also obtain price information and news from several third-party news sources such as Reuters and industry news letters. In addition to consulting these sources, surveillance analysts conduct frequent telephone interviews with both cash and futures market participants and industry analysts in order to compare price data, analyze the supply and demand components of the market, and identify unusual or abnormal price relationships.

Market Surveillance analysts also review the previous trading day's volume and open interest for their assigned contracts on a daily basis. Volume and open interest data are available to analysts in Volume and Open Interest Reports generated by the LTRS (discussed *supra* p. 26).

These reports display statistical data concerning volume and open interest at the exchange level, contract level, and product level. They provide both volume and open interest for a given trade date and the change up or down from the previous trade date, as well as the percentage of open interest represented by the positions of individual large traders. In addition, analysts can consult the “Futures CFTC Report,” which lists each clearing member’s long and short positions and total open interest in each CME and CBOT futures contract for the previous trading day.

## 2. Deliverable Supply for Physically Delivered Commodities

Market Surveillance closely monitors the available deliverable supplies in the Exchanges’ agricultural contracts principally via data collected and maintained by the Registrar’s Office. In connection with this, the Registrar’s Office produces several reports that allow Market Surveillance to monitor the deliverable supply of products stored in Exchange-approved warehouses. The Deliverable Commodities Under Registration Report (“DCUR”) is published on the Exchanges’ web site on a daily basis and shows the deliverable receipts and certificates by commodity (i.e., wheat, oats, corn, ethanol, corn, distillers’ dried grain, soybeans, soybean oil, soybean oil, and rough rice), facility, and territory.<sup>29</sup> The DCUR enables Market Surveillance analysts to monitor how many delivery instruments there are in a particular market at any given time. If there is a low amount of delivery instruments and a low amount of stocks, Market Surveillance heightens its awareness as to potential market congestion and delivery issues, and accordingly contacts market participants. The Daily Receipts and Shipments Report is also published daily on the Exchanges’ web site and includes the receipts of grain into Exchange-approved warehouses and delivery of grain out of the warehouses. This report enables Market Surveillance analysts to understand the liquidity and flow of the cash market. Additionally, the

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<sup>29</sup> A shipping certificate is a call on demand for delivery of a commodity at a specified location and does not require a product to be stored at the facility when the certificate is created. Rather, the facility needs to be ready to load out the commodity within a specified time period when the holder of the certificate demands delivery.

Registrar's Office publishes the Stocks of Grain Report each Tuesday, which shows the stocks of grain on hand in regular facilities, by delivery territory, as of the previous Friday. Market Surveillance analysts use this report to compare figures from the previous week in order to assess any material changes in deliverable supply. This report is also used to determine if there is an adequate supply of grain with dispersed rather than concentrated ownership, and whether there are sufficient stocks of grain available for delivery. Market Surveillance supplements the analysis derived from each of these reports by contacting clearing members and large traders directly with deliverable supply inquires relating both to upcoming contract expirations and to general market conditions. Finally, Market Surveillance is proactive in anticipating future trends in the markets. For example, if Market Surveillance anticipates an unusually dry or wet season that could dramatically impact supply, Market Surveillance analysts will reach out to market participants to understand their plans better (e.g., whether they will be using exemptions, rolling positions into future months) so as to predict the layout for future months.

Although futures contracts that require the delivery of a financial instrument are less likely than futures on physical commodities to be subject to manipulation in the form of a squeeze, Market Surveillance analysts nevertheless monitor the available supply, including the size of particular issues that are cheapest to deliver.<sup>30</sup> To the degree there is a small issue in size that is entering the delivery period, Market Surveillance will heighten its awareness, particularly of participants in the market. In addition, analysts closely scrutinize conversion factors on any particular delivery instrument in the financial markets to understand if there will be a large or small conversion factor on the final settlement day. Market Surveillance also will reach out to participants, reminding them of their delivery obligations to ensure an orderly liquidation.

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<sup>30</sup> Cheapest to deliver refers to the selection of a class of bonds or notes deliverable against an expiring bond or note futures contract. The bond or note that has the highest implied repo rate is considered the cheapest to deliver.

The Division believes the Exchanges have an effective procedure for routine surveillance of market fundamentals, including the monitoring of price, volume, open interest, and deliverable supply. Accordingly, the Division has no recommendations in this area.

**D. Surveillance of Expiring Contracts**

1. Standard Procedures for Heightened Surveillance

Market Surveillance heightens surveillance of expiring contracts in order to detect and prevent price manipulations and facilitate orderly liquidations. Heightened surveillance typically begins approximately two weeks prior to a spot month and continues throughout this period. Market Surveillance analysts conduct daily review of the trading and positions of large traders, in light of the current state of open interest and the size and ownership of deliverable supply for physical delivery contracts. They also monitor cash market prices, supplies, transportation rates, cost of carry, and other factors that could affect an orderly liquidation. In addition, staff analyzes unusual short supply indications, atypical spread and basis relationships, abnormal price relationships among cash, futures, and options markets, and other unusual market circumstances that could raise the potential for liquidation problems. Market Surveillance analysts develop an understanding of the participants who are involved in their markets and seek to identify any unusual participants holding positions in them.

Market Surveillance analysts also communicate frequently with participants via telephone interviews as expirations near. Such expiration-related communication ordinarily commences both with market participants that hold the most significant positions in order to confirm the positions appearing in LTRS reports and ascertain the participants' expectations going forward, as well as with participants not usually seen in the market. Conversations early in the expiration cycle often start with generalities related to market conditions and, as the

expiration approaches, become more specific about hedging, economics, the need for the commodity, and logistics associated with making or taking delivery. Holders of short positions may be asked if they hold any of the underlying products and, as the expiration nears, their intentions regarding delivery. Because markets are more likely to be squeezed from the long side, holders of long positions will generally be solicited for details regarding any underlying cash products (e.g., bonds, notes, corn, or CBOT registered receipts) that they may hold. Market Surveillance staff also routinely shares information concerning contract expiration issues with Commission staff.

To the extent there is a manipulation concern regarding a participant, Market Surveillance raises the issue internally and ultimately, if the problem persists, with Market Regulation's Enforcement Group ("Enforcement") for potential emergency action. Such situations are rare, as Market Surveillance staff usually, through conversations with the participant, can reach a resolution regarding the participant's strategy and methodology as well as ensuring that the participant understands the Exchanges' expectations for an orderly liquidation. During the target period, there were no instances where Market Surveillance referred a contract expiration issue to Enforcement for emergency action.

## 2. Expirations During the Target Period Requiring Heightened Surveillance

The Exchanges identified six contract expirations that required particular scrutiny during the target period: November 2010 CME Cash-settled Butter, September 2011 CME S&P 500 futures contracts, October 2011 CME Live Cattle futures contracts, March 2011 CBOT Corn futures contracts, July 2011 CBOT Wheat futures contracts, and July 2011 CBOT Ethanol futures contracts. To ascertain Market Surveillance's process for determining orderliness for these six expirations, the Division examined the files for each and interviewed Market

Regulation and Market Surveillance personnel. The Division found that the Exchanges' expiration files generally contained similar, consistent, and adequate documentation, including Large Trader Reports, Volume and Open Interest Reports, Cash Market Values, and conversation logs with relevant participants. The Division notes that for each of these six non-routine expirations, Market Surveillance took a slightly different approach (e.g., opening research and case files in some instances) and generally had an adequate and appropriate process for handling the expiration-specific market conditions and factors. The Division finds that Market Surveillance's procedures largely resulted in early detection of the potential problems and that Market Surveillance took responsive steps, including contact with market participants, additional review of trading activity, and opening research and case files when necessary. Each of the six contract expirations culminated in an orderly fashion.

The Exchanges have an adequate procedure for heightening surveillance of expiring contracts to detect and prevent price manipulations and facilitate orderly liquidations. For the six expirations requiring heightened scrutiny during the target period, Market Surveillance responded appropriately to the expiration-specific market factors, ensured orderliness, and kept well-documented files. Accordingly, the Division has no recommendations in this area.<sup>31</sup>

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<sup>31</sup> As discussed *supra* note 4, after the target period ended, the Commission issued new rules related to DCMs, which became effective in October 2012. 77 Fed. Reg. 36,612 (June 19, 2012). Among other things, the Commission issued Regulation § 38.252, which relates to convergence. Specifically, Regulation § 38.252 enhances the price discovery process by helping to detect disconnects between futures prices and underlying physical market prices. As the Commission stated, "Close monitoring of physical-delivery contracts helps prevent the manipulation of prices, and the public benefits from futures prices that reflect actual market conditions because those prices often form the basis for transactions taking place in the physical market." *Id.* at 36,680. Accordingly, the Division notes that, while the Exchanges have demonstrated adequate abilities in detecting cash-physical disconnects in the six expirations analyzed during this review, these new rules may change the scope of the Division's concerns going forward, and the Exchanges may need to enhance their abilities to comply with these new rules.

## **E. Position Accountability Levels and Speculative Position Limits**

### **1. Standard Procedures for Position Accountability Levels and Position Limits**

At the Exchanges, the size of market participants' positions is subject to two types of monitoring and control: position accountability levels and position limits.<sup>32</sup> A position accountability level can be thought of as a threshold that triggers additional scrutiny of a position by Market Surveillance and gives Market Regulation certain powers to address potential market problems; it is not a limitation on the size of a trader's position, and positions in excess of the accountability level are not violations of the Exchanges' rules. Market Regulation purposefully sets accountability levels low to provide for regulatory flexibility.<sup>33</sup> Accordingly, holding a position that exceeds a position accountability level is a common occurrence.

Accountability levels are established based on Market Regulation staff assessment of available data, such as deliverable supply information and projected open interest, and are set when a product is launched. They can be adjusted periodically, and adjustments thereto constitute rule filings that are subject to approval by the Commission or the Commission's self-certification procedures.<sup>34</sup>

To determine position size, CME and CBOT net long and short futures positions and convert option positions to their futures equivalents. When the size of a market participant's net position exceeds the applicable position accountability level, CME and CBOT rules require the participant to provide various types of information to the Exchanges at their request, including the nature and size of the position, the trading strategy being employed, and information

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<sup>32</sup> The Exchanges list the position accountability and position limit levels for each contract, where applicable, in the Position Accountability and Reportable Level Table in Chapter 5 of the CME and CBOT Rulebooks.

<sup>33</sup> CME and CBOT Rule 560 (Position Accountability).

<sup>34</sup> CEA § 5c(c); 17 C.F.R. §§ 40.5, 40.6.

demonstrating whether the position is a hedge or is speculative in nature. Further, where there is concern about the size of a position, CME and CBOT rules give Market Regulation authority to direct a participant to reduce any position where the participant fails to provide information requested with respect to a position above the position accountability level.<sup>35</sup>

Position limits also are set when a product is launched and may be adjusted periodically, subject to approval by the Commission or the Commission's self-certification procedures. They are broken down into three types: spot month, single month, and all-months-combined. Position limits bar a market participant from holding or controlling a net futures equivalent position that exceeds the position limit for the contract in question (whether for the spot month, single month, or all-months-combined). The particular position limit may be adjusted in individual instances by a hedge exemption granted to the participant by the Exchange (discussed *infra* Section IV.F.1).<sup>36</sup> The spot month period varies by contract and is defined in the rule for each product. Exceeding a position limit without previously having obtained an exemption, or without filing in the next business day for an exemption after the position is assumed, is a rule violation.<sup>37</sup>

## 2. Monitoring of Position Accountability Levels and Position Limits

Market Surveillance uses separate methods to monitor positions that exceed position accountability levels and positions that exceed speculative position limits. First, regarding position accountability, Market Surveillance analysts are responsible for monitoring positions in excess of accountability levels for their markets on a daily basis. Analysts do this by employing a new functionality available in the LTRS that identifies all market participants holding positions

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<sup>35</sup> CME and CBOT Rule 560.

<sup>36</sup> CME and CBOT Rule 559 (Position Limits and Exemptions).

<sup>37</sup> CME and CBOT Rule 559; CME and CBOT Rule 560.

at, or in excess of, accountability levels both on a futures only basis and on a futures equivalent basis. For each market participant in excess of a position accountability level, the analyst preliminarily assesses the regulatory significance of the position, considering factors such as whether the participant holds a significant portion of the outstanding open interest in the product, the nature of the participant's business, the type of position, market fundamentals, whether the participant has exhibited abrupt position accumulation or uncharacteristic behavior in the marketplace, and the absolute position size relative to the size of open interest in the contract, to other position holders, and to historical position levels for the account.

If the analyst believes that a particular position poses a potential risk to fair and orderly markets, he or she obtains additional information related to the nature of the position, the trading strategy, and, if necessary, specific representations from the position holder. For any positions that remain a concern, the analyst meets with his or her supervisor promptly to discuss any potentially necessary action, such as continuing to monitor the position closely, obtaining additional information, directing the participant not to increase the position (i.e., a Do Not Increase ("DNI") Order), establishing a prospective position limit, or directing the participant to reduce his or her position. The OTL Report contains functionality that enables Market Surveillance to track DNI Orders on an absolute or a percentage basis. In the event that Market Surveillance orders the participant not to increase or reduce a position, Market Surveillance shares this information with Commission staff.

Second, regarding position limits, the Large Trader Group within Market Surveillance has primary responsibility for identifying potential speculative position limit violations. Each morning, Large Trader staff utilizes the OTL Report to ascertain instances where traders have exceeded position limits for the prior day, the amount by which they may have exceeded limits,

the futures equivalent open interest for the particular products, and the percentage of open interest the traders hold. That same morning, after identifying potential violations, Large Trader staff verifies the positions by contacting the relevant firms, and notifies the surveillance analysts, who then manage any pending hedge exemption application or investigate the potential limit violation.

To identify intraday position limit violations, a Lead Market Surveillance Analyst outside of the Large Trader Group has responsibility for detecting such violations.<sup>38</sup> This analyst utilizes the Intraday OTL Report, SMART, and RAPID to identify potential intraday violations. Once identified, he or she sends the firm an email memorializing the firm's notification of the potential violation and follows up with the firm accordingly.

A Program Administrator is responsible for initiating speculative limit case files in Legal Files (discussed further *infra* next Section), uploading all relevant information gathered by Large Trader staff, assigning the case to the applicable analyst as directed by the responsible manager, and noting whether the participant has requested an exemption. The responsible manager supervises the case's progress, reviews the case file to ensure all components are included, and is responsible for closing the case, which may include issuing a warning letter or scheduling a referral conference with Enforcement. While the Large Trader Group has primary responsibility for detecting violations, Market Surveillance reminds all surveillance analysts of their ongoing responsibility to proactively identify positions that may exceed spot month speculative limits if not reduced and to take appropriate preemptive remedial action.

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<sup>38</sup> Market Surveillance uses an analyst outside of the Large Trader Group for this review because examining potential intraday violations entails review of trade data, not large trader data.

3. Position Accountability and Position Limit Research and Case Files

a. *Standard Procedures for Research and Case Files*

During the target period, the Exchanges revamped their process for tracking work concerning potential violations (position limit related and otherwise) and for storing related documentation. Specifically, on November 1, 2010, the Exchanges implemented the Legal Files case management system, an electronic tracking and storage tool that Market Surveillance analysts utilize to document, access, and maintain information related to potential rule violations. In Legal Files, Market Surveillance analysts can open two types of files: case files or research files.<sup>39</sup> The file type distinction is embedded in the file numbers logged in Legal Files (i.e., “CASE,” “RSRH”). Matters initiated as case files generally are matters that are deemed to have reasonable indications of potential rule violations at the time the matters are initiated. All other matters are initiated as research files, indicating that the referenced activity merits further review, but is not yet deemed to have sufficient indication of potential rule violations to merit initiating the matter as a case. When a matter is initiated via a customer complaint, the matter is initially logged in Legal Files with a “COMP” prefix embedded in the file number. Following review, the matter then will be either closed if there is no credible indication of a potential rule violation, or referred to a case with a “CASE” designation if there is sufficient indication of a violation.

Position accountability reviews, in which written responses are requested from participants, are initiated as research files. An accountability review only transitions to a case file if a participant is ordered to “hold” or “decrease” his or her position, and he or she violates that order.

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<sup>39</sup> Prior to November 1, 2010, the Exchanges utilized an investigation/inquiry distinction. This terminology is no longer used by the Exchanges.

As part of the position limit monitoring described above, the Large Trader Group, after assembling information and contacting the FCM, determines whether an instance where a participant exceeds the position limit will likely be eligible for a hedge exemption or is not eligible and will be processed as a position limit violation.<sup>40</sup> Likewise, the Lead Market Surveillance Analyst determines the likelihood that instances where intraday position limits are exceeded will result in violations. If it appears that a position is likely to represent a limit violation or requires validation that the position is a bona fide hedge eligible for an exemption, the matter is opened as a case file. If the analysis indicates that the position is unlikely to represent a violation (which is more likely to be the case for intraday citations),<sup>41</sup> the matter is logged as a research file.

*b. Number of Position Accountability and Position Limit Research and Case Files*

During the target period, the Exchanges opened 13 position accountability research files for trading on CME and six for trading on CBOT, as well as one position accountability case file for trading on CBOT. Further, the Exchanges closed 20 position accountability research files and one case file for trading on CME, eight of which were opened before the target period and 13 of which were opened during it. The Exchanges closed five position accountability research files and one case file for trading on CBOT, one of which was opened before the target period and five of which were opened during it. All position accountability matters closed during the target period were resolved without incident. There were no position accountability research

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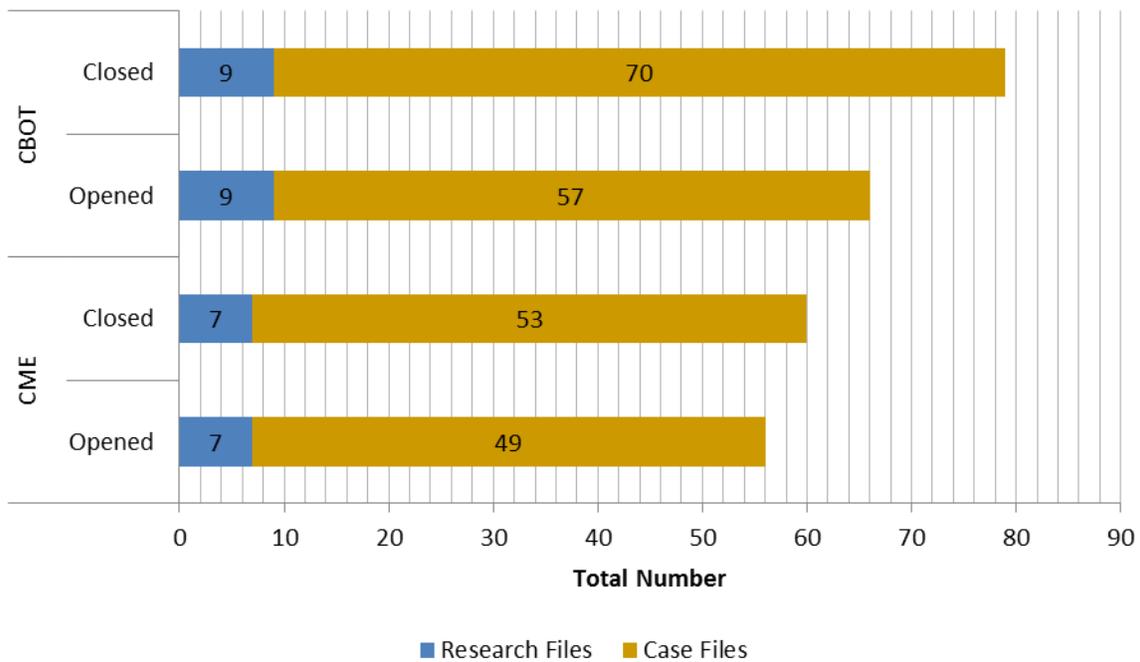
<sup>40</sup> As described in greater detail *infra* next Section, CME and CBOT Rule 559 provide that where a participant exceeds a speculative position limit, he or she has one business day (or up to five business days if extended by Market Regulation) to apply for a hedge exemption retroactively to avoid a position limit violation.

<sup>41</sup> Intraday violations are more likely to result in research files, because at the time a violation is noted, analysts may not have access to all of the participant's execution accounts and additional analysis may also be required to accurately sequence trades executed on different venues or bilaterally. After Market Surveillance conducts this work, it is often the case that the position is found to be in compliance with the applicable position limit.

files or case files opened prior to the target period that remained open at the conclusion of the target period.

Regarding potential position limit violations, as seen in Figure 4 below, the Exchanges opened seven research files and 49 case files into potential position limit violations related to trading on CME and a comparable nine research files and 57 case files into potential position limit violations related to trading on CBOT. Additionally, the Exchanges closed seven research files and 53 case files related to position limit violations on CME, 12 of which were opened before the target period and 48 of which were opened during it. The Exchanges closed nine research files and 70 case files related to position limit violations on CBOT, 19 of which were opened before the target period and 60 of which were opened during it. There was one CME position limit case file that was opened during the target period and closed after the target period.

**Figure 4 – Number of Position Limit Research and Case Files Opened and Closed During the Target Period**



c. *Documentation of Position Limit Research and Case Files*

The Division reviewed approximately half of all the closed position limit research and case files (26 for CME and 30 for CBOT) for documentation, adequacy of sanctions, and timeliness.<sup>42</sup> Where a speculative position limit research or case file was resolved with a hedge exemption being granted, the documentation contained the hedge application, analyses justifying the exemption, and the approval letter (discussed further *infra* Section IV.F.1). With respect to all other position limit matters, the Division found that the Exchanges' research and case files were documented with pertinent underlying trading documents, correspondence, computer reports, and summaries of the trading activity examined. Documentation also included Investigation Reports that described the details surrounding the investigations, including how the matter was initiated, the facts developed during the course of the investigation, summaries of interviews, and Market Regulation staff's analysis and conclusions, and/or brief close-out memoranda that summarized the investigation and conclusion.<sup>43</sup> The Division finds that the Exchanges generally maintain adequate documentation for position limit research and case files and that the Investigation Reports and close-out memoranda contained sufficient information for Division staff to make an informed decision regarding the adequacy of the investigations.

However, the Division found that nearly every Investigation Report, while containing a completion date, did not contain signatures by either the surveillance analyst or senior staff member reviewing the case. In addition, almost all of the close-out memoranda contained a date

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<sup>42</sup> Regarding position accountability, the Division also reviewed nine of the 20 closed CME research files for CME and five of the six closed CBOT research files. The Division found no issues with respect to these.

<sup>43</sup> While almost all of the files contained Investigation Reports, only some files additionally contained brief close-out memoranda, and the Division was unable to ascertain a reason for the presence or absence of these memoranda. Because the Investigation Reports were more comprehensive than the close-out memoranda and contained sufficient information to enable the Division to analyze the files, the Division was not concerned with the absence of close-out memoranda in some cases. Nevertheless, Market Regulation has advised the Division that, going forward, there will be a single, comprehensive report for all matters.

field designed to auto-update whenever the file is opened.<sup>44</sup> This deficiency prevented the Division from verifying the completion dates for many cases (apart from a summary spreadsheet provided by the Exchanges listing opening and closing dates for all matters during the target period). While likely more formalistic than substantive shortcomings, the absence of signed Investigation Reports and accurately dated close-out memoranda hinders transparency with respect to both whether a particular resolution was subject to review by a senior Market Regulation staff member and the timeliness with which Market Regulation completed work on research and case files. Accordingly, the Division recommends that the Exchanges ensure that all Investigation Reports for research and case files contain signatures by the appropriate personnel and that all close-out memoranda contain accurate dates. (The Division notes that these control issues were present across all matter types it reviewed (i.e, position limit, EFRP (discussed *infra* Section IV.G), and miscellaneous (discussed *infra* Section IV.H)) and thus this recommendation should be considered global in nature.)

*d. Adequacy of Sanctions for Position Limit Cases*

During the target period, in addition to implementing Legal Files, the Exchanges also changed their procedure for issuing sanctions for position limit violations. In April 2010, CME and CBOT undertook the process to change from an automatic fine structure for position limit cases (as formerly provided for under Rule 443<sup>45</sup>) to a more flexible approach, which considers the facts and circumstances of each case and also evaluates whether the liquidation of the

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<sup>44</sup> The Division appreciates that the Exchanges recognized this deficiency and notified the Division of it when the Exchanges produced documents for this review.

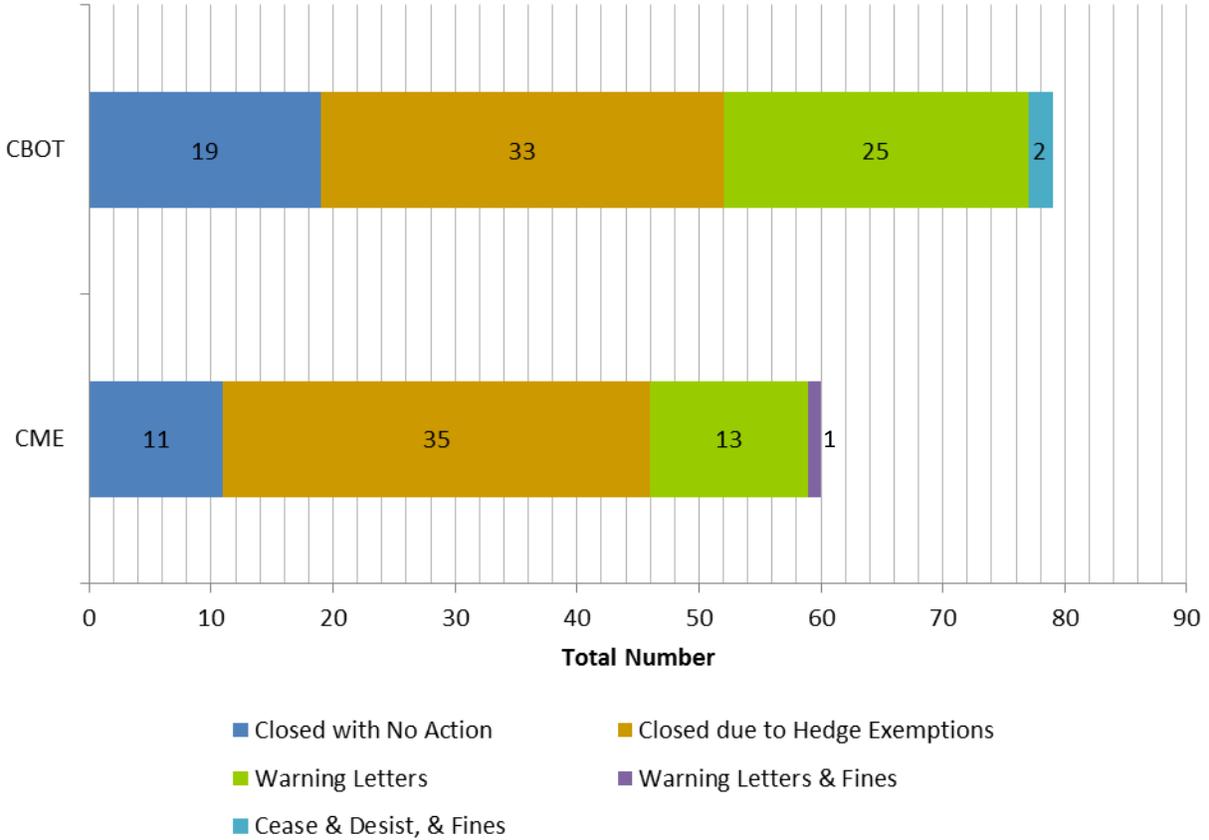
<sup>45</sup> Prior to this change, Rule 443 provided that the first occurrence of a position limit violation would automatically result in a warning letter; the second occurrence of a position limit violation within 24 months of issuance of the first violation's warning letter would automatically result in a \$5,000 or \$15,000 fine depending on the extent to which the participant exceeded the applicable limit; and any third or subsequent occurrence of a position limit violation within 24 months of the first violation's warning letter would automatically result in referral to the Probable Cause Committee for consideration of the issuance of charges.

overage yielded profits for which disgorgement should be sought as part of the sanction for the position limit violation. Effective November 29, 2010, the Exchanges revised and relocated Rule 443 to Rule 562. Under Rule 562's framework, the Exchanges now determine position limit sanctions on a case-by-case basis and additionally seek disgorgement of the profit earned as a result of the position limit violation, unless the profit is considered de minimis. Due to the process in determining a methodology for calculating profit (and loss) in position limit cases, Market Regulation suspended the resolution of position limit cases from April 2010 through March 2011. This led to delays in the resolution of position limit case files (discussed further *infra* next Section).

Under the Exchange's new framework, Market Regulation generally issues warning letters for first-time position limit violations that generate no or de minimis profit for the participant involved and schedules referral conferences with Enforcement where profit is involved. All second offenses incurred within a 12-month period, regardless of whether profit is gained, are referred to Enforcement.

The Division reviewed 26 CME position limit research and case files and 30 CBOT position limit research and case files for adequacy of sanctions. Further, the Division reviewed a chart provided by the Exchanges that provided the dispositions for all research and case files closed during the target period. Figure 5 below provides the disposition breakdown of all research and case files related to potential position limit violations.

**Figure 5 – Disposition of Closed Research and Case Files Related to Position Limit Violations During the Target Period**



For the three above cases that resulted in fines, the Exchanges issued fines of \$5,000, \$15,000, and \$15,000, respectively. The Division reviewed all three of these cases as part of the 56 files reviewed for the Exchanges. In all three cases, the participants had committed their second offense within a 24-month period, and all fell under the old Rule 443’s automatic fine structure.<sup>46</sup> The Division found that the Exchanges followed Rule 443’s automatic fine structure appropriately.

The Division identified one case where the market participant exceeded its long-side, all-months-combined position limit in Ethanol futures, did not file an application for a retroactive

<sup>46</sup> See discussion of Rule 443 *supra* note 45.

hedge exemption in accordance with the Exchanges' rules, and did not receive any warning letter or sanction for the violation. Specifically, the Exchanges' rules provide that if a market participant exceeds a position limit, the participant may avoid a speculative limit violation by filing a retroactive hedge exemption application demonstrating its eligibility for an exemption within one business day after assuming the relevant position except in circumstances where Market Regulation has expressly approved a later filing which may not exceed five business days.<sup>47</sup> In this case, correspondence in the case file shows that Market Regulation notified the participant of the potential violation on the next business day after the position was assumed and advised the participant that, if the positions were carried for hedging purposes, the participant was required to submit a completed hedge application that same day to avoid a violation. Though the participant did not file its hedge exemption application until the seventh business day after assuming the position, Market Surveillance approved the retroactive exemption application and did not treat the exceeding of position limits as a violation of the Exchanges' position limit rules. The Division believes that if a market participant does not file a timely hedge exemption application in accordance with the timeframe prescribed by the Exchanges' rules, then the participant should not receive the benefit of a retroactive hedge exemption, and the violation should be treated in accordance with the Exchanges' position limit rules.

In addition, the Division identified one case where the Division believes that Market Surveillance should have referred the matter to Enforcement instead of issuing a warning letter. In this case, Market Surveillance determined that the participant held 6,857 long contracts in December 2009 Wheat futures, which exceeded the position limit in Wheat futures of 6,500 contracts (the respondent was allowed to carry 5,000 contracts in a single month and an

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<sup>47</sup> See CME and CBOT Rule 559 (Position Limits and Exemptions). See *infra* Section IV.F.1 for further discussion of this rule.

additional 1,500 contracts as part of a spread position in the same crop year, for a maximum single month limit of 6,500 contracts) by 357 contracts, or 5.4 percent above the limit. Market Surveillance contacted the participant to advise him of the overage and to provide an opportunity for him to respond to the apparent violation. Market Surveillance learned through the participant's FCM that the position limit violation had allegedly occurred due to a substantial directional move in the wheat spreads market, and that the participant had stated that he sold over 1,600 contracts upon learning of the violation. In fact, after informing Market Surveillance that he would be in compliance within 15 minutes, the participant continued to increase his position the next day before placing a 1,000-lot spread trade to bring the position in compliance with Exchange rules.<sup>48</sup> Market Surveillance calculated that the liquidation of the overages yielded a \$173 profit.

The Division believes that where a trader commits a position limit violation and then flouts Market Surveillance's directive by increasing his or her position, a warning letter is insufficient. This case was decided under the new Rule 562 framework, which affords Market Surveillance the discretion to refer any case to Enforcement. The Division believes Market Surveillance should have utilized this discretion in this case and in all future cases involving egregious conduct.<sup>49</sup> The Division recognizes that the participant's overage was relatively low

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<sup>48</sup> The Division notes that the case file for this violation contained two Investigation Reports prepared by two different analysts. The Exchanges informed the Division that after the initial report was drafted, the case had been transferred to a second analyst in conjunction with the process changes to the program and explained that the first Investigation Report was a draft that was erroneously maintained in the electronic case file and should be disregarded.

<sup>49</sup> The Division notes that while Rule 562 does not expressly state that "egregious" cases warrant fines or referrals by Market Regulation to the Probable Cause Committee ("PCC") or Business Conduct Committee, the CME and CBOT Rulebooks do repeatedly provide for this authority for other rule violations. *See, e.g.*, CME and CBOT Rule 514.B (regarding Trading Infractions, "Notwithstanding the above, the Market Regulation Department may, at any time, refer matters that it deems egregious to the Probable Cause Committee"); CME and CBOT Rule 515.E (same language for violations of restrictions on trading); CME and CBOT Rule 536.F (same language for Globex Order Entry violations).

compared to the participant's total position and that the profit earned on the liquidation of the overage was small. Moreover, the Division notes that Market Surveillance stated during the interview for this review that the matter should have been referred to Enforcement based upon the fact that the participant had added to his position after being advised that his position was in excess of the speculative limit. The Division strongly believes that the participant's apparent willful disregard of Market Surveillance's instructions warranted a referral by Market Surveillance to Enforcement. In the Division's view, the issuance of charges by Enforcement and the prospect of meaningful sanctions were necessary to deter the participant in this case as well as are imperative to deter other participants from committing the same or similar offenses. Accordingly, the Division recommends that Market Surveillance use the discretion afforded under its position limit rules to respond with referrals to Enforcement when egregious conduct occurs.

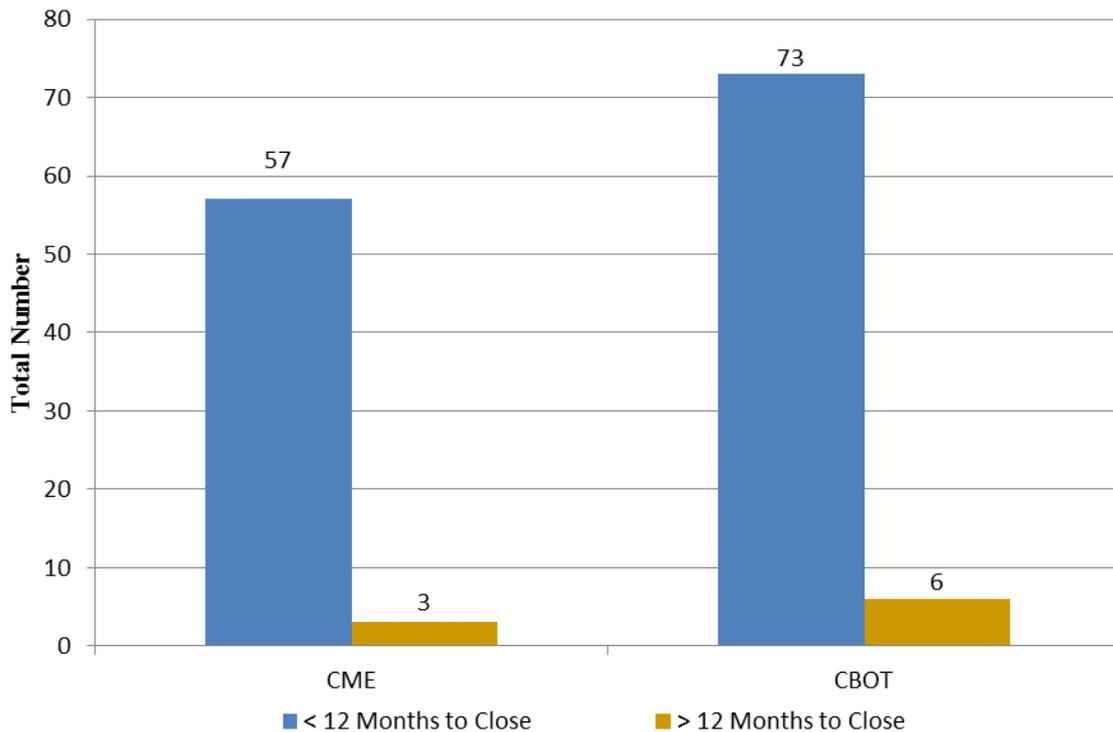
*e. Timeliness for Resolving Position Limit Research and Case Files*

As indicated below in Figure 6, of the 60 total CME position limit research and case files closed during the target period, three had been open for longer for one year; and of the 79 total CBOT position limit research and case files closed during the target period, six had been open for longer than one year.

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Further, even under the old Rule 443, Market Regulation would still have had the discretion to refer this matter to the PCC. While Rule 443 laid out an automatic fine structure for position limit violations, the rule also stated, “[N]otwithstanding Sections A. and B. of this rule [providing the automatic framework for first and subsequent violations], the Market Regulation Department, in its sole discretion, may refer any position limit violation it deems egregious to the PCC for consideration of the issuance of charges.”

**Figure 6 – Timeliness of Closed Position Limit Research and Case Files During the Target Period**



Division staff examined in detail all nine of the above case files that were open over one year as well as the one case that was opened prior to the target period and closed shortly thereafter. Division staff also interviewed Market Regulation personnel to determine whether there was any justification for their prolonged open periods. During this review, Market Regulation attributed the delay in closing the majority of these cases to the fact that they were opened during the time period when the Exchanges were engaged in the several-month process to change from Rule 443’s automatic fine structure to the new process of calculating

disgorgement.<sup>50</sup> While the Division commends the Exchanges for implementing a new disgorgement methodology that will result in sanctions more proportionate to position limit violations and will better deter misconduct, the Division believes that this explanation is not acceptable to justify suspending the resolution of cases for the year-long period from April 2010 to March 2011. Accordingly, the Division recommends that the Exchanges not adopt any new rule or process until they first take appropriate measures to ensure they can effectively and promptly implement that rule or process without delaying the resolution of matters for an undue amount of time (*see infra* Section IV.H for discussion and recommendation with respect to timeliness).

### **Recommendations with Respect to Position Accountability Levels and Speculative Position Limits**

The Exchanges have adequate procedures to monitor the size of participants' positions via position accountability levels and to enforce speculative position limits. During the target period, the Exchanges' research and case files were typically well-documented; however, Investigation Reports were nearly all unsigned by the relevant personnel and many close-out memoranda did not include accurate dates. The Exchanges issued fines for three cases that were closed during the target period, and all were justified by the facts of each case. The Division identified one case where the market participant exceeded a position limit and failed to file a retroactive hedge exemption application until the seventh business day after assuming the relevant position. Though the Exchanges' rules require a participant to file a retroactive hedge exemption application, to avoid a position limit violation, within one business day after assuming the position except in circumstances where Market Regulation has expressly approved a later filing which may not exceed five business days, Market Surveillance nevertheless approved the untimely application and did not treat the matter as a position limit violation. In addition, the Division identified one case, in which the participant continued to increase its position despite notification of a position limit violation, where Market Surveillance should have used its discretion to refer the matter to Enforcement. In addition, while the Exchanges resolved the majority of matters in a timely manner, nine cases were closed during the target period that had been open for over 12 months. In the majority of these nine cases, Market Regulation explained that the delays in resolution were due to the process of changing from Rule 443's automatic fine

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<sup>50</sup> Other potentially mitigating circumstances included the complexity of the cases and the seriousness of the potential violations, while Market Regulation conceded that there was no mitigating circumstance for one case that was opened in March 2010 and closed in May 2011.

structure to a new, more robust methodology for calculating disgorgement in position limit cases. Accordingly, the Division recommends that:

- **The Exchanges ensure that, for all research and case files, Investigation Reports contain signatures by the relevant personnel and close-out memoranda contain accurate dates.**
- **The Exchanges not grant a retroactive hedge exemption if a participant does not file a timely application within the timeframe provided in the Exchanges' rules. If a market participant fails to submit a timely retroactive hedge exemption application, the speculative limit violation should be treated as a violation of the Exchanges' speculative limit rules.**
- **Market Surveillance utilize its discretion to refer matters to Enforcement for the prospect of meaningful sanctions and to deter participants from committing egregious conduct, such as continuing to increase positions after notification by Market Surveillance of position limit violations.**
- **The Exchanges should not implement any new rule or process until they first take appropriate measures to ensure that they can effectively and promptly implement the rule or process without delaying the resolution of affected cases for a prolonged amount of time.**

## **F. Hedge Exemptions from Position Limits**

### **1. Standard Procedures for Exemption Applications**

Although all participants are subject to the Exchanges' single month, spot month, and all-months-combined position limits where applicable, the Exchanges may grant exemptions from position limits to participants holding bona fide hedge positions, risk management positions, or arbitrage and spread positions.<sup>51</sup> Exemptions may be granted in all Exchange products except treasuries. To obtain an exemption, the participant must file an exemption application in which the participant must:

- (i) Provide a description of the exemption sought, including whether the exemption is for bona fide hedging, risk management, or arbitrage/spread positions;

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<sup>51</sup> CME and CBOT Rule 559.A-C.

- (ii) Provide a complete and accurate explanation of the underlying exposure related to the exemption request;
- (iii) Agree to promptly provide, upon request by Market Regulation, information or documentation regarding the participant's financial condition;
- (iv) Agree to comply with all terms, conditions, or limitations imposed by Market Regulation with respect to the exemption;
- (v) Agree that Market Regulation may, for cause, modify or revoke the exemption at any time;
- (vi) Agree to initiate and liquidate positions in an orderly manner;
- (vii) Agree to comply with all Exchange rules; and
- (viii) Agree to promptly submit a supplemental statement to Market Regulation whenever there is a material change to the information provided in the most recent application.<sup>52</sup>

Beginning in the fourth quarter of 2009, the Exchanges restructured their application process to request historical information directly related to the type of hedging allowed in Commission Regulation 1.3(z).<sup>53</sup> Market Surveillance distributed new applications to participants holding exemptions at this time. Participants wishing to continue holding exemptions submitted new applications, and Market Surveillance used the new data contained in them to issue new hedge exemption levels.

Upon receiving a completed application, Market Surveillance uses the information provided by the applicant to justify the appropriate hedge exemption levels. Historical monthly data is compared to the applicant's current inventory levels, fixed price purchases and sales, and anticipatory needs for hedgers that are processors, feeders, or millers. Justifications and approvals are reviewed by the hedge team, and approval letters are drafted and signed by the Director overseeing the hedge exemption program. Signed approval letters are then emailed to the participant and the FCM(s) where the hedger maintains positions. Market Surveillance grants exemptions based on the hedger's justified needs and the relevant market's ability to

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<sup>52</sup> CME and CBOT Rule 559.

<sup>53</sup> 17 C.F.R. § 1.3(z).

absorb positions of the magnitude granted. An exemption must be renewed annually by the participant and failure to do so results in expiration of the exemption.<sup>54</sup> If a participant exceeds a position limit, Exchange rules afford the participant one business day to apply for an exemption retroactively to avoid a position limit violation, though Market Surveillance may extend this period for up to five business days.<sup>55</sup> Market Surveillance maintains a Pending Hedge List, which lists participants that have exceeded position limits but have filed for an exemption. If Market Surveillance deems the position ineligible for a retroactive exemption, Market Surveillance will find the applicant and clearing firm in violation of speculative limits for the period of time in which the excess positions remained open.<sup>56</sup>

Market Surveillance maintains a hedge exemption file for each applicant, which contains the application, Market Surveillance work papers, and the Exchanges' written grant of the application. When a participant contacts Market Surveillance to obtain an exemption application, staff discusses with the participant the nature of the cash exposure underlying the request. If staff determines that the exposure does not fall within Rule 559's guidelines, the participant is notified at that time and no application is typically filed. Because of this "pre-work," it is rare that an application is officially filed and denied. During the target period, there were no such denials.

## 2. The Division's Review of 16 Representative Exemption Files

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<sup>54</sup> CME and CBOT Rule 559. In November 2009, CME Group harmonized the annual renewal requirement across all of its DCMs.

<sup>55</sup> CME and CBOT Rule 559. Some circumstances where Market Surveillance might grant a participant up to five business days to file an exemption application retroactively include where the participant might need more time to submit an application, such as in the case of a foreign entity, or where Market Surveillance is otherwise comfortable that the participant will be eligible for an exemption.

<sup>56</sup> CME and CBOT Rule 559.

During the target period, Market Surveillance took action on and approved 420 exemption applications for products traded on CME and CBOT, including 114 new exemption applications, 295 applications for renewal, 10 applications for increased levels, and one temporary exemption on an inter-commodity spread. The Division reviewed representative hedge exemption files for each of CME and CBOT's 16 product markets.<sup>57</sup> Each file contained three documents: (i) the application submitted by the participant; (ii) the Excel workbooks containing three main spreadsheets used by the hedge team to document and analyze the application; and (iii) the approval letter sent to the participant specifying the levels and categories corresponding to the application.

Based on the Division's review of the 16 representative exemption files, the Division is concerned that Market Surveillance is not rigorously requiring that applicants submit complete and accurate applications prior to receiving hedge exemptions. The Division believes that, by strictly requiring participants to submit applications that are complete and designate accurate hedging categories, Market Surveillance will increase transparency and orderliness, and ultimately make its hedge exemption process more robust.

First, the Division found several instances where exemptions were granted despite missing information in the applications. For example, a Dairy futures hedge exemption application was lacking information in several sections, including Tag 50 information, the clearing firm account number and account executive, and all of the narrative questions concerning the applicant's operations as they related to the hedging activity. In addition, a Rough Rice application did not specify the exemption levels requested and rather only denoted the types of exemptions being sought. Both the Rough Rice and Russian Rubles applications

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<sup>57</sup> These product markets were Corn, Currency, Dairy Complex, Feeder Cattle, Lean Hogs, Live Cattle, Nasdaq 100, Nikkei, Oats, Rough Rice, Soybean Meal, Soybean Oil, Soybeans, S&P 400, S&P 500, and Wheat.

examined by the Division were missing the relevant clearing firm account numbers, and the Corn, Lean Hogs, Live Cattle, Russian Rubles, and Soybean Meal applications reviewed were all missing Tag 50 information. While the Division recognizes that some sections of applications may be less critical than others, the Division nevertheless believes that Market Surveillance should strictly require complete applications from applicants prior to granting exemptions. Accordingly, when a participant submits an application missing any information, Market Surveillance should notify the applicant and require a complete and accurate application prior to granting any exemption.

In addition, the Division found instances where Market Surveillance granted exemptions for hedging categories different from those requested in the applications, and there was no documentation in the exemption files to explain the changes. The Exchanges' hedge exemption application requires the applicant to specify the type of enumerated or non-enumerated hedge sought. The three types of enumerated hedge are: (1) ownership of the same cash commodity; (2) the quantity equivalent of fixed price sales and/or purchases of the cash commodity and/or derivative products of such commodity; or (3) cross-hedging of cash commodity. The two types of non-enumerated hedge are: (1) unfilled and/or unsold anticipated positions in the same cash commodity; or (2) cross-hedging related to the value of anticipated cash positions. Specifically, the Division found that Market Surveillance granted exemptions for hedge categories different from those requested in the Dairy, Feeder Cattle, Oats, Soybean, Soybean Meal, and Soybean Oil exemption applications reviewed. In the case of all of these applications, there was no documentation in the files to explain how or why Market Surveillance arrived at the decision to grant hedge exemptions for hedging category(ies) different from those requested. Market Surveillance informed the Division that, in some circumstances, applicants may designate

categories incorrectly or fail to provide information in the application sufficient to support the particularly designated category. In such instances, if Market Surveillance finds an applicant's business and exposure is sufficient to justify an exemption under a category different from that selected by the applicant, the exemption will be approved in a different category from that requested. While the Division found that, for the six files listed above, there was sufficient justification in the applications to justify the hedging category(ies) granted, the lack of documentation as to why Market Surveillance changed the category(ies) hindered the Division's ability to assess Market Surveillance's hedge exemption process. The Division believes it is critical that hedge exemptions not be granted unless and until an application is complete and accurate. If an applicant selects a category that Market Surveillance believes is inappropriate, then Market Surveillance staff should notify the applicant and request that the application be amended to select an appropriate category if warranted. Without a complete and accurate application signed by the applicant, there is not a complete legal record and hedge exemptions may be granted that are not justified.

Accordingly, the Division recommends that the Exchanges ensure that all applications for hedge exemptions contain all necessary information and accurately set forth the hedging category(ies) for which the Exchanges will grant approval.<sup>58</sup> Where an application is missing information or requests a hedging category that is incorrect or not justified by the application, the Division recommends that the Exchanges require the participant to correct the application accordingly.

3. Exemption Levels Granted Versus Exemption Levels Requested During the Target Period

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<sup>58</sup> The Division notes that one potential, robust solution would be for Market Surveillance to implement a computerized system for hedge exemption applications that would not accept any applications with any fields missing.

In addition to reviewing the 16 representative files discussed above, the Division also reviewed a spreadsheet provided by the Exchanges that listed all exemptions granted during the target period, detailing, for each exemption, the level requested, the level granted, and the type of exemption. The Division also separately asked the Exchanges to identify any instances where the exemption levels granted exceeded the levels requested. The Division identified 12 participants during the target period for whom Market Surveillance granted exemption levels in excess of the levels requested by the participants. Three of these 12 participants received excess levels for two types of positions (i.e., short spot and short non-spot). These 15 instances occurred for all types of positions: long spot month, short spot month, long non-spot month, short non-spot month, long all-months-combined (“AMC”), and short AMC, and are listed in Table 2 below:

**Table 2: Instances Where Approved Exemption Levels Exceeded Requested Levels During the Target Period**

<b>Product</b>	<b>Requested Level</b>	<b>Approved Level</b>
Cash Settled Butter	100 Long Spot	200 Long Spot
Cash Settled Butter	100 Long Spot	200 Long Spot
Dry Whey	83 Short Spot	100 Short Spot
Feeder Cattle	1,095 Short Spot	1,100 Short Spot
Lean Hogs	14,000 Long Non-Spot	14,050 Long Non-Spot
Lean Hogs	7,500 Long Non-Spot 10,000 Short Non-Spot	14,050 Long Non-Spot 14,050 Short Non-Spot
Lean Hogs	10,000 Long Non-Spot	14,050 Long Non-Spot
Live Cattle	522 Short Spot 2,175 Short Non-Spot	950 Short Spot 2,530 Non-Spot

Oats	436 Long AMC 1,696 Short AMC	440 Long AMC 1,700 Short AMC
Soybean Meal	1,950 Short AMC	27,910 Short AMC
Soybeans	62,000 Short AMC	132,000 Short AMC
Wheat	6,067 Short AMC	6,070 Short AMC

In the case of the nine participants shaded in orange above, Market Surveillance granted exemption levels above the levels requested, and the Exchanges stated that Market Surveillance had granted the exemption levels based on the participants' demonstrated exposure rather than the requested exemption levels. In the case of the three participants shaded in blue above, Market Surveillance indicated that it had rounded up the exemption levels to the nearest 10 from the requested level. For all 15 approvals listed above, Market Surveillance stated that, despite the errors in approving the exemptions at levels in excess of the requested amount, all approved levels were fully justified by the exposure submitted by the participants. Additionally, Market Surveillance acknowledged that these errors were due to an oversight and subsequently informed the Division that it has addressed this issue. Specifically, after this rule enforcement review was commenced, Market Surveillance revised its Hedge Exemption Manual to state that the Program Administrator and Senior Director will verify that exemption levels to be granted do not exceed the levels requested before final sign off.

The Division additionally analyzed large trader data for each of the nine participants above that received excess exemption levels without any justification to ascertain these participants' actual position sizes for each day that the respective hedge exemption was effective and, accordingly, to determine whether or not they in fact utilized the excess levels granted. The Division believes that a lack of usage of the excess levels granted demonstrates that the initial exemption levels requested by the participants represented the actual hedge amounts warranted

and is further evidence that the excess amounts granted were unnecessary. The Division found that only one of the participants actually used the extra increment granted by Market Surveillance. Specifically, for the participant shown above who requested a Lean Hogs exemption for 7,500 Long Non-Spot and 10,000 Short Non-Spot, the participant's requested long-side limit should have been 11,650 contracts (4,150, the CME standard speculative limit in any contract month for Lean Hogs + 7,500, the requested exemption), rather than the 14,050 granted. The Division noted that this participant held 11,986 contracts on one day during March 2010, thus exceeding its requested limit by 336 contracts.

The Division is concerned about these instances where Market Surveillance granted exemptions for participants at levels higher than those requested and finds this practice to be inappropriate under any circumstance. The Division's concerns are heightened by the fact that, with one small exception, none of these participants utilized the excess levels granted. Under Exchange rules, an exemption should be granted only on the basis of bona fide hedging, risk management, or arbitrage/spread exposure for the market participant involved. The circumstances by which exemptions were erroneously granted at levels higher than those requested calls into question the adequacy of the quality controls for Market Surveillance's hedge exemption process.

Accordingly, the Division recommends that Market Surveillance monitor its hedge exemption process closely and ensure that its new sign-off procedure, as now provided for in the Hedge Exemption Manual, is preventing any exemptions from being granted at exemption levels above those requested by participants. The Division advises that, when examining the present number of staff to ensure staffing levels are adequate to implement the recommendations in this

report,<sup>59</sup> the Exchanges take into account the need to have sufficient Market Surveillance staff to review hedge exemption applications in a manner consistent with the recommendations immediately below.

### **Recommendations with Respect to Hedge Exemptions from Position Limits**

Market Surveillance has procedures for reviewing hedge exemption applications. However, the Division believes that Market Surveillance's process could be more robust by administering certain changes. In reviewing representative hedge exemption files across all of the Exchanges' product markets, the Division found that the files included the subject application, work papers justifying the exemption granted, and an approval letter. However, the Division found that several of the applications were incomplete and that several applicants received exemptions for hedging categories different from those requested. In addition, the Division is concerned that Market Surveillance granted exemptions levels for 12 participants in excess of the levels the participants had requested. Accordingly, the Division recommends that:

- **Market Surveillance ensure that, prior to granting a hedge exemption, the applicant has submitted a complete and accurate application and has designated the appropriate hedging category(ies).**
- **Market Surveillance monitor its hedge exemption program to ensure that its procedures prevent an exemption from being granted at a level above that requested by an applicant.**

#### **G. Monitoring of EFRPs<sup>60</sup>**

##### **1. Standard Procedures for EFRPs**

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<sup>59</sup> See *supra* staffing recommendations at the end of Section IV.A.

<sup>60</sup> The findings and recommendations contained in this Section are limited to the Division's analysis of and conclusions drawn from: (i) the specific EFRP cases reviewed as part of this Rule Enforcement Review (i.e., the EFRP cases identified by the Exchanges that were opened during the target period, closed during the target period, or open throughout the target period); (ii) a copy of the Market Surveillance EFRP Transaction Review Program Manual provided to the Division (with a last updated date of January 7, 2012); (iii) current CME and CBOT Rule 538 and a June 11, 2010 Market Regulation Advisory Notice relating to EFRPs published by CME Group; (iv) interviews by the Division with Market Regulation personnel; and (v) other internal analyses performed by the Division.

The Exchanges' Rule 538 (Exchange for Related Positions) provides CME and CBOT's applicable rule governing EFRP transactions. It presently provides for three different types of EFRPs, including Exchange for Physicals ("EFP"), Exchange for Risk ("EFR"), and Exchange for Options ("EOO").<sup>61</sup> An EFP transaction is a privately negotiated and simultaneous exchange of a futures position for a corresponding cash market position in the same or a related cash instrument. An EFR transaction is a privately negotiated and simultaneous exchange of a futures position for a corresponding OTC swap or other OTC derivative in the same or a related instrument.<sup>62</sup> An EOO transaction is a privately negotiated and simultaneous exchange of an exchange-traded option position for a corresponding OTC option position or other OTC contract with similar characteristics in the same or a related instrument.<sup>63</sup>

EFRPs may be transacted in any of the Exchanges' futures and options contracts.<sup>64</sup> An EFRP consists of two discrete but related simultaneous transactions. One party to the EFRP must be the buyer of (or the holder of the long market exposure associated with) the related position and the seller of the corresponding Exchange contract; the other party to the EFRP must be the seller of (or the holder of the short market exposure associated with) the related position and the buyer of the corresponding Exchange contract.<sup>65</sup> Rule 538 states that an EFRP's related position (i.e., the cash commodity, an OTC swap, an OTC option, or other OTC derivative) must

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<sup>61</sup> CME and CBOT Rule 538 (Exchange for Related Positions).

<sup>62</sup> As previously discussed, during the target period, CME eliminated the EFS identifier and brought EFS transactions under the EFR umbrella, and after the target period had concluded, CBOT likewise eliminated the EFS identifier. *See supra* note 9.

<sup>63</sup> CME Group, Market Regulation Advisory Notice No. CME Group RA1006-5, Exchange for Related Positions at Q&A #1 (June 11, 2010), *available at* <http://www.cmegroup.com/rulebook/files/RA1006-5.pdf>.

<sup>64</sup> *Id.* at Q&A #5.

<sup>65</sup> CME and CBOT Rule 538.A (Nature of an EFRP); CME Group, *supra* note 63, at Q&A #6.

involve the commodity underlying the Exchange contract, or must be a derivative, by-product, or related product of such commodity that has a reasonable degree of price correlation to the commodity underlying the Exchange contract.<sup>66</sup> In addition, the quantity covered by the related position must be approximately equivalent to the quantity covered by the Exchange contracts.<sup>67</sup> Rule 538 states that parties to an EFRP transaction must denote the date and time of execution of all EFRP transactions on the standard record required for all customer orders; however, EFRP transactions entered into ClearPort do not require a separate record of the transaction or time of execution provided that such transactions are entered immediately after the relevant terms have been determined, but in no event later than the earlier of the start of the next business day or the end of the permissible posting period for EFRP transactions following the expiration of the underlying futures contract.<sup>68</sup> Parties to EFRP transactions must also designate EFRP transactions as such and clear them through CME Clearing.<sup>69</sup>

In addition, Rule 538 states that “[c]learing member firms are responsible for exercising due diligence as to the bona fide nature of EFRP transactions submitted on behalf of customers.”<sup>70</sup> Parties to any EFRP transaction must maintain all documents relevant to the Exchange contract and the cash, OTC swap, OTC option, or other OTC derivatives, and it is the

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<sup>66</sup> CME and CBOT Rule 538.B (Related Positions).

<sup>67</sup> CME and CBOT Rule 538.C (Quantity).

<sup>68</sup> CME and CBOT Rule 538.E (Date and Time of Transaction). The Exchanges offer clearing services for OTC transactions through CME ClearPort. ClearPort is the CME Group’s centralized, comprehensive system that provides clearing services in multiple asset classes. ClearPort uses a central counterparty clearing model whereby counterparty credit risk is shared among clearing members. When EFRPs are submitted via ClearPort, the buyer and seller enter into a trade off the Exchanges, on a bilateral basis, and then post the EFRP directly to ClearPort. The clearing house then clears the transaction in the same manner as other Exchange contracts, thus reducing counterparty risk for the OTC transaction parties.

<sup>69</sup> CME and CBOT Rule 538.G (Identification and Submission to the Clearing House)

<sup>70</sup> CME and CBOT Rule 538.G.

responsibility of the carrying clearing member firm to provide any such requested documentation to the Exchanges at their request.<sup>71</sup>

The Exchanges' Rule 538 also requires that the accounts involved on each side of an EFRP be: (i) independently controlled accounts with different beneficial ownership; (ii) independently controlled accounts of separate legal entities with the same beneficial ownership, provided that the account controllers operate in separate business units; (iii) independently controlled accounts within the same legal entity, provided that the account controllers operate in separate business units; or (iv) commonly controlled accounts of separate legal entities, provided that the separate legal entities have different beneficial ownership. Each clearing member, omnibus account, and foreign broker submitting large trader positions also must include the EFRP volume bought and sold in the reportable instrument, by contract month, and additionally for EOOs, by put and call strike.<sup>72</sup>

In addition to Rule 538, in June 2010, Market Regulation issued an Advisory Notice to provide market participants with further guidance with respect to EFRP transactions.<sup>73</sup> Among other things, Market Regulation stated that two parties may not execute an EFRP transaction and an additional cash or OTC transaction that offsets the cash or OTC component of the EFRP (called "transitory EFRPs" by the Exchanges), except for CME foreign exchange products, NYMEX energy and metals products, and COMEX metals products.<sup>74</sup> Market Regulation also

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<sup>71</sup> CME and CBOT Rule 538.H (Documentation); CME Group, *supra* note 63, at Q&A #9, Q&A #25.

<sup>72</sup> CME and CBOT Rule 538.J (Account Requirements); CME Group, *supra* note 63, at Q&A #8, Q&A #28.

<sup>73</sup> CME Group, *supra* note 63.

<sup>74</sup> *Id.* at Q&A #9.

reiterated Rule 538.G, stating that “[a] firm that executes and submits an EFRP on behalf of a customer is responsible for exercising due diligence as to the bona fide nature of the EFRP.”<sup>75</sup>

## 2. Monitoring EFRPs

Market Surveillance maintains a team of surveillance analysts that, among other tasks, is assigned to front-end EFRP monitoring (as discussed *supra* p. 21). In addition, Market Surveillance states that a Program Administrator, who is a member of this team, functions as a dedicated EFRP specialist and reviews EFRPs across all markets. As part of its front-end EFRP surveillance, Market Surveillance staff utilizes the Market Review of Ex-Pit Data (“MRED”) computer application within the SMART system, which is designed to help detect potential violations of Exchange rules as they pertain to EFRP transactions. As stated in Market Surveillance’s EFRP Transaction Review Program Manual (“EFRP Manual”), examples of EFRPs meriting further review include transactions where a participant rolls positions (i.e., liquidates a position for one delivery month and then reestablishes it for the next delivery month), does not ordinarily engage in EFRPs, executes an EFRP in an unusual amount of contracts, executes an EFRP at a futures price outside the daily range for the relevant contract, executes an EFRP tied to a spread transaction, or executes an EFRP in a product market where EFRP activity is not ordinarily observed. Once an EFRP is identified as meriting further review, the matter is initiated as a case file in Legal Files. As a practice, Market Surveillance only initiates case files for potential violations of EFRP rules; Market Surveillance does not open research files related to EFRPs and therefore does not document queries conducted by analysts through the MRED system. In addition, Market Surveillance only requests documentation

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<sup>75</sup> *Id.* at Q&A #24; *see also id.* at Q&A #11.

related to an EFRP from the carrying clearing firm when that transaction results in the opening of a case.

An EFRP case consists of four phases: Request, Pre-Analysis, Analysis, and Review. In the Request phase, the EFRP team analyst submits a document request to the firm(s) involved in the EFRP in question. Both carrying clearing firms are required to produce documentation associated with the EFRP transaction by a certain deadline (usually within 10 business days). Requested documentation includes trade confirmations, futures account statements, order tickets, and underlying documentation showing the cash leg of the transaction (e.g., cash blotters or cash tickets). The analyst is required to maintain an activity sheet that details all requests, conversations, pertinent dates, and notes related to the case. In the Pre-Analysis phase, the analyst ensures that all material necessary to conduct the review has been obtained from the carrying clearing firm(s). In the Analysis phase, the Market Surveillance analyst reviews all documentary material provided to determine whether the EFRP meets the requirements of Rule 538 and, accordingly, is a bona fide EFRP transaction. The analyst follows up with the firms or participants when necessary. Upon completion of the review, the analyst creates a report that includes a summary of his or her findings and, if necessary, a recommendation for closure or further action via referral to the Program Administrator. In the last Review phase, the Program Administrator reviews all files for completeness, adequacy, and concurrence with the recommendation related to the overall review. If closure is recommended, the Program Administrator will approve the summary report as final and submit it to the supervising Associate Director for final sign off. If the case is referred for disciplinary action, the Program Administrator will act as liaison to Enforcement to coordinate Market Surveillance cooperation with the assigned staff attorney through ultimate disposition of the case.

### 3. EFRP Cases

During the target period, 484,218 total EFRP transactions were executed at the Exchanges (317,799 for CME and 166,419 for CBOT).<sup>76</sup> Market Surveillance opened seven case files for CME and nine case files for CBOT related to EFRP transactions. During the target period, Market Surveillance also closed five EFRP-related cases for CME (three of which were opened before the target period and two during it) and eight cases for CBOT (four of which were opened before the target period and four during it). In reviewing the 13 EFRP cases closed during the target period, the Division found that Market Surveillance primarily targeted agricultural products, specifically corn contracts, and verified the bona fides of EFRPs relating to very few other products. Specifically of the 13 closed cases, seven related to agricultural products (five to corn), three related to treasuries, one related to Eurodollars, one related to a currency, and one related to an equity index. Of the five closed CME cases, one concluded with a warning letter, and of the eight closed CBOT cases, three concluded with warning letters.<sup>77</sup> The other cases concluded with no action. Market Surveillance's EFRP Manual does not provide that parties and clearing firms to cases resulting in sanctions (e.g., the four EFRP cases resulting in warning letters during the target period) are subject to any heightened scrutiny or deeper inquiry for other potentially violative EFRPs. Two cases were opened prior to the target

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<sup>76</sup> See *supra* Table 1 at p. 17 for a breakdown of the different types of EFRPs during the target period. In addition, the 317,799 EFRPs executed at CME accounted for 11,023,712 contracts, and the 166,419 EFRPs executed at CBOT accounted for 30,403,246 contracts.

<sup>77</sup> Additionally, a CME EFRP case initiated from contract surveillance was resolved during the target period and resulted in sanctions against a firm of \$80,000 for the execution of non-bona fide EFRPs; shortly after the target period, a second firm involved in the matter was fined \$100,000 and its employee was fined \$20,000 and suspended for 10 days.

period and remained open at the conclusion of the target period (one at CME and one encompassing both Exchanges).<sup>78</sup>

The Division reviewed all 13 of the EFRP-related case files that were closed during the target period, as well as files for the two cases that were opened prior to the target period and closed after it. Generally, the Division found that Market Surveillance closed its cases in a timely manner. Of the 13 cases closed within the target period, 12 were closed within 12 months. However, the Division identified one case that was opened in Legal Files in October 2009 and closed in April 2011, and there were no apparent extenuating circumstances justifying the prolonged open period. Of the two cases that were closed after the target period, the Division found that one of the cases involved a complex fact pattern and serious violations mitigating the delay in its resolution. However, Division staff was unable to find any mitigating circumstance justifying the delay in resolving the other case. Accordingly, the Division believes that Market Surveillance should ensure that it closes cases within 12 months absent mitigating circumstances (*see infra* Section IV.H for discussion and recommendation with respect to timeliness).

In addition, the Division found that, for these 13 cases, Market Surveillance's investigations were thorough. The Division found that each case file was well documented, containing: (i) an Investigation Report detailing the facts, investigation, and recommendation; (ii) all correspondence and submitted documentation; (iii) appropriate analyses; (iv) activity logs documenting the course of the case; and (v) charts describing the flow of the futures and the related product. Some files additionally contained brief close-out memoranda.<sup>79</sup> Market

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<sup>78</sup> The Division notes that one of these two cases was resolved after the target period and resulted in sanctions against the clearing firm of \$1,750,000, as well as sanctions against the firm's employee of \$150,000 and a 10-month suspension.

<sup>79</sup> *See supra* note 43.

Surveillance routinely analyzed the futures price relative to the day's trading range, as well as the price differential (basis price) at which the related product and futures contracts were exchanged, to determine if the differential reflected market prices.<sup>80</sup>

While the Exchanges generally completed EFRP cases in a timely manner and documented EFRP cases adequately when they occurred, the Division believes that the Exchanges' present procedures for monitoring EFRP transactions are inadequate. First, the Division is concerned that Market Surveillance's MRED queries and other analyses triggered the opening of only 16 EFRP-related cases during the target period, as compared to the 484,218 total EFRPs transacted on the Exchanges during the target period. The Division notes that it could not quantify the number of EFRPs informally analyzed through MRED, as MRED queries are not documented. Nevertheless, given the relatively small number of EFRP cases opened during the target period as well as the growth in the number of EFRPs transacted since the 2010 Review period, the Division recommends that the Exchanges examine the factors and procedures they use to identify EFRP transactions that warrant the opening of case files to ensure that they are adequately targeting, reviewing, and, where necessary, escalating potentially problematic EFRPs.

Second, the Division finds that the Exchanges have an inadequate program for ensuring that parties to an EFRP transaction maintain relevant documents pursuant to CME and CBOT Rule 538.H's documentation requirements and, accordingly, for verifying the bona fides of a sufficiently large, strategically selected sample of EFRPs. An improved and robust program is necessary both to uncover non-bona fide EFRPs as well as to deter parties from entering into and clearing firms from processing non-bona fide EFRPs. As noted above, Rule 538.H requires parties to any EFRP transaction to maintain all documents relevant to the Exchange contract and

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<sup>80</sup> Just as with the position limit files, Investigation Reports were unsigned by the relevant personnel, and the majority of the close-out memoranda contained a date field programmed to auto-update whenever the file is opened (*see* global recommendation *supra* Section IV.E).

the cash, OTC swap, OTC option, or other OTC derivative, and holds carrying clearing member firms responsible for providing such documentation to the Exchanges at their request. Because Market Surveillance's practice is to request documentation to verify the bona fide nature of an EFRP only when a case is opened, the Exchanges only verified compliance with their documentation requirements in 16 new instances during the target period (i.e., for well less than one percent of all EFRPs transacted). As Market Surveillance staff acknowledged during this review, Market Surveillance's present practice differs from the procedures detailed in its EFRP Manual, which provides:

Surveillance analysts with contract surveillance responsibilities will be required to conduct a specified number of reviews each year in the products to which they are assigned in order that they maintain competence in transactions impacting those markets. On an ongoing basis the Program Administrator, using available tools, is responsible for selecting a representative sample of EFRP transactions for review.

The Division strongly believes the Exchanges overall need a robust process for verifying clearing firms' compliance with Rule 538.H's documentation requirements and, in turn, verifying the bona fides of a sufficient number of strategically selected EFRPs. A substantially improved EFRP-monitoring process is necessary for the Exchanges to have an adequate process for detecting non-bona fide EFRPs in their markets. Specifically, the Division believes Market Surveillance, at a minimum, should subject all clearing firms that clear EFRPs to a more robust audit process. Market Surveillance should request documentation for and verify the bona fides of multiple EFRP transactions including all EFRP types (EFPs, EFRs, and EOOs) across every product category at least once every calendar year for every carrying clearing member firm that clears EFRPs on the Exchanges. While Market Surveillance may utilize a degree of randomization in selecting the EFRPs for verification, Market Surveillance should choose the

EFRPs with an eye to detecting potentially violative transactions. In addition to the examples of EFRPs that would warrant heightened scrutiny listed in the EFRP Manual, Market Surveillance should closely examine, among other things, EFRPs involving an unusually small number of contracts such as one-lot EFRPs, EFRPs just below the respective block size threshold, EFRPs between affiliates, parties that conduct a large number of EFRPs, and parties that execute offsetting EFRPs on the same day.

Moreover, when Market Surveillance finds potentially violative behavior, it should then expand the scope of its investigation into the clearing firm and parties associated with the EFRP to check for other violations or patterns of violative behavior. This further inquiry should include analyses of past EFRPs associated with the clearing firm and parties, and Market Surveillance should subject future EFRPs concerning the clearing firm and parties to heightened scrutiny. When sampling EFRPs to review, Market Surveillance should request documentation relevant to the EFRP as required by Rule 538.H to verify the bona fide nature of each EFRP sampled (i.e., trade confirmations, futures account statements, order tickets, and underlying cash documentation).

The Division recognizes that the recommendations in this Section necessarily increase the workload for Market Surveillance. Therefore, the Division advises that when examining their present number of staff to ensure staffing levels are adequate to implement the recommendations in this report, the Exchanges take into account the need to enhance their EFRP program consistent with the recommendations in this Section.

Accordingly, because the Division believes it is of paramount importance that the Exchanges improve their process for monitoring EFRPs significantly and promptly, the Division requests that the Exchanges submit to the Division within 60 days of the publication of this

report a revised EFRP Manual that incorporates these recommendations as well as a statement as to changes in staffing or any other areas the Exchanges have performed to comply with the recommendations in this Section.

### **Recommendations with Respect to Monitoring of EFRPs**

The Exchanges have inadequate procedures for monitoring EFRP transactions. CME and CBOT Rule 538 provides the applicable rule governing EFRP transactions and, among other things, holds clearing firms responsible for exercising due diligence as to the bona fide nature of EFRP transactions. Market Surveillance analysts monitor EFRPs via the MRED application within the SMART system. The Exchanges open case files for EFRPs that indicate potential Exchange rule violations and only request documentation for EFRPs that are involved in cases. During the target period, the Exchanges closed 13 EFRP cases. The Division found that these 13 cases generally were closed in a timely manner and well-documented. However, none of the Investigation Reports were signed by the relevant personnel, and the majority of the close-out memoranda contained incorrect dates. The Exchanges also only opened 16 EFRP cases during the target period, as compared to the 484,218 total EFRP transactions executed during the period. The Exchanges did not sample any other EFRPs, outside of the 16 EFRPs resulting in cases, to verify their compliance with Rule 538's documentation requirements and, accordingly, verify their bona fides. Accordingly, the Division recommends that:

- **Market Surveillance ensure that the factors and procedures it uses to identify EFRPs that warrant the opening of case files are adequately targeting problematic EFRPs.**
- **Market Surveillance establish an adequate and robust program to ensure that parties and clearing firms to EFRP transactions maintain relevant documents pursuant to the Exchanges' rules and, accordingly, verify the bona fides of a sufficiently large, strategically selected sample of EFRPs. Specifically, the Exchanges should subject all clearing firms that clear EFRPs to a strict audit process whereby the Exchanges:**
  1. **Request documentation for (including all documents relevant to the Exchange contract and the cash, OTC swap, or other OTC derivatives) and verify the bona fides of multiple EFRP transactions (including EFPs, EFRs, and EOOs) across every product category at least once every calendar year;**
  2. **Strategically select the EFRPs for review with an eye to detecting misconduct; and**

3. **Subject any clearing firm and parties to a violative EFRP to heightened scrutiny, including analyses of past EFRPs and future EFRPs.**

#### **H. Miscellaneous Research and Case Files Reviewed by the Division**

In addition to the position accountability, position limit, and EFRP research and case files discussed *supra* Sections IV.E & IV.G, the Exchanges opened six miscellaneous research files (four for CME and two for CBOT) and 13 miscellaneous case files (seven for CME and six for CBOT) related to other types of violations as well as five files initiated via customer complaints (four for CME and one for CBOT). These miscellaneous research matters related to such potential violations as delivery, disruptive trading, manipulation, excessive bids/offers, aggregation, large trader reporting, open interest reporting, regularity reporting, and non-competitive trading. In sum, the Exchanges opened a total of 41 research files (24 for CME and 17 for CBOT), 136 case files (63 for CME and 73 for CBOT), and five files from customer complaints (four for CME and one for CBOT) during the target period.

In addition, the Exchanges closed nine miscellaneous research files (seven for CME and two for CBOT) and 11 miscellaneous case files (one for CME and 10 for CBOT) as well as three files initiated via customer complaints related to CME trading. Of these 23 closed matters, 16 were opened prior to the target period and seven during it. In sum, the Exchanges closed a total of 50 research files (34 for CME and 16 for CBOT), 149 case files (60 for CME and 89 for CBOT), and three files from customer complaints (all for CME) during the target period. Nine miscellaneous cases opened prior to the target period remained open at the end of the period.

Of the nine miscellaneous research files, 11 miscellaneous case files, and three customer complaint files closed across both Exchanges during the target period, all nine research files, all

complaint files, and eight of the 11 case files were closed within 12 months. Of the three cases open over 12 months, one featured a complex fact pattern and serious allegations of market manipulation. Division staff was unable to determine any mitigating circumstance for the other two cases justifying their prolonged open periods, one of which was open from May 2005 to May 2011 and the other from June 2009 to June 2011. The Division also reviewed all files for the nine other cases that were opened prior to the target period and either closed after the target period or, in some cases, still remain open. While the Division found mitigating circumstances justifying the delays in some instances (e.g., complexity of the allegations, seriousness of violations), the Division has concerns regarding significant delays in resolving the majority of these nine matters. Specifically, Division staff found instances where there were prolonged periods of inactivity, where internal activity logs were not kept up to date, and where investigations were completed in a timely fashion yet the Investigation Reports or administrative closure was delayed for no apparent reason. Accordingly, the Division is concerned regarding the Exchanges' process for resolving all matters in a timely manner (including the position limit and EFRP cases discussed *supra* Sections IV.E.3 & IV.G.3) as well as the Exchanges' process for keeping orderly files, such as up-to-date activity logs.

The Division therefore recommends that the Exchanges work to ensure that all matters are closed in a timely manner absent mitigating circumstances and that all matters are documented in an orderly fashion, including up-to-date activity logs.

Division staff reviewed the files of all nine miscellaneous research files, all 11 miscellaneous case files, and all three complaint files that were closed during the target period

for adequacy of sanctions and documentation.<sup>81</sup> Of these files closed across both Exchanges during the target period, two were closed with warning letters and the rest closed with no action. The Division's review included both cases closed with warning letters, and in both, the sanctions appear reasonable and appropriate in light of the violations. Moreover, the Division generally found that Market Surveillance's research and case files were typically well-documented and included pertinent underlying trade documents, correspondence, computer reports, recording of witness interviews (when applicable), and summaries of the activity examined. When necessary, cases were broadened in scope to look for patterns of violations. Cases were either closed with no action due to insufficient evidence or warning letters issued. Cases that were closed with no further action included an Investigation Report and/or close-out memorandum that typically contained a description of the investigation conducted and sufficient information for Division staff to make an informed decision regarding the adequacy of the investigation.<sup>82</sup>

### **Recommendations with Respect to Miscellaneous Research and Case Files Reviewed by the Division**

In addition to the position accountability, position limit, and EFRP research and case files previously discussed, Market Surveillance opened six research files, 13 case files, and five matters initiated via customer complaints related to other types of violations (e.g., delivery, disruptive trading, manipulation, excessive bids/offers, aggregation) across both Exchanges during the target period. In addition, Market Surveillance closed nine research files, 11 case files, and three matters initiated via customer complaints related to these other types of violations. The Division found that the sanctions, where given, were adequate and the files were well-documented; however, all except one Investigation Report were signed and close-out memoranda frequently contained inaccurate dates. Of the closed matters, the Division found that two were open over 12 months without any mitigating circumstance. In addition, the Division found nine matters that were opened prior to the target period and remained open after it, the majority of

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<sup>81</sup> When coupled with Division staff's review of the position accountability, position limit, and EFRP research and case files already discussed, Division staff reviewed a total of 106 files of the 202 research files, case files, and files initiated via customer complaint that were closed during the target period.

<sup>82</sup> As with the position limit and EFRP files, Investigation Reports were unsigned by the relevant personnel, and the majority of the close-out memoranda contained a date field programmed to auto-update whenever the file is opened (*see* global recommendation *supra* Section IV.E).

which did not have mitigating circumstances justifying their prolonged open periods. Accordingly, the Division recommends that:

- **The Exchanges ensure that all research and case files are closed within 12 months of the date they are opened, absent extenuating circumstances, and that all research and case files contain orderly documentation, including up-to-date activity logs.**