

For Public Release

**RULE ENFORCEMENT REVIEW
OF
ONECHICAGO, LLC**



**Division of Market Oversight
April 7, 2014**

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RULE ENFORCEMENT REVIEW OF ONECHICAGO

I. INTRODUCTION

The Division of Market Oversight (“Division”) has completed a rule enforcement review of the trade practice surveillance program of OneChicago, LLC (“OneChicago” or “Exchange”).¹ The review covered the target period of July 1, 2011 to June 30, 2012 (“target period”),² and focused on compliance with two core principles under Section 5(d) of the Commodity Exchange Act (“Act”),³ as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).⁴ In particular, the Division’s review focused on Core Principles 2 (*Compliance With Rules*) and 12 (*Protection of Markets and Market Participants*) which relate to an exchange’s trade practice surveillance program.

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

² The Division last completed a rule enforcement review of OneChicago in July 2005. The target period was August 1, 2003 through December 31, 2004. In that review, the Division reviewed the Exchange’s compliance with Core Principles 2 and 12, Core Principles 4 and 5 (prevention of manipulation and price distortion, and the enforcement of speculative position limit and position accountability rules), Core Principles 10 and 17 (audit trail), and Core Principle 13 (alternative dispute resolution program). The Division made no recommendations.

³ 7 U.S.C. 1 *et seq.*

⁴ *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010). The Division’s review focused on Sections 5(d)(2) (“Core Principle 2”) and 5(d)(12) (“Core Principle 12”) of the Act as amended by the Dodd-Frank Act because the Core Principles as amended by the Dodd-Frank Act were in effect for approximately eleven months of the target period.

II. METHODOLOGY

The Division interviewed Exchange staff and received a demonstration of the Exchange's electronic trade practice surveillance system, called Csystem. The Division also reviewed numerous documents used by OneChicago in carrying out the Exchange's routine oversight responsibilities. These documents included the following:

- Minutes of all meetings of the OneChicago Regulatory Oversight Committee ("ROC") held during the target period;
- Documents summarizing Exchange trade practice surveillance activities and procedures;
- Screenshots of exception reports and other work product generated by the Exchange's automated surveillance systems;
- Documents listing target period trade modifications and cancellations and pauses and halts;
- Files and records concerning trade practice inquiries (referred to as "investigations" by the Exchange) and investigations (referred to as "cases" by the Exchange) closed during the target period; and
- Logs of investigations and cases during the target period generated by the Exchange.

The Division provided the Exchange an opportunity to review and comment on a draft of this report on February 14, 2014. On March 4, 2014, Division staff conducted an exit conference with Exchange officials to discuss the report's findings and recommendations.

III. SUMMARY OF FINDINGS AND RECOMMENDATIONS

A. Compliance Department and Staffing

Findings

- OneChicago's trade practice surveillance is conducted by the Compliance Surveillance Department ("CSD"). The CSD consists of three positions: the Chief Regulatory Officer ("CRO"), the Director of Market Regulation, and the Market Regulation Analyst.
- OneChicago's CRO departed the Exchange in January 2011. The position of permanent CRO remained unfilled until November 2013, when the Director of Market Regulation was promoted to CRO after serving as the Director of Market Regulation for approximately six months.
- The Director of Market Regulation position is now vacant. The Division is concerned by the CRO's relative inexperience and the lack of a Director of Market Regulation. These factors may place strain on the ability of the Exchange's Compliance Surveillance Department to perform daily surveillance activities and fulfill the Exchange's self-regulatory responsibilities.
- The Exchange did not have a formal compliance manual during the target period. After the end of the target period, the Exchange created a compliance manual dated January 29, 2013 (the "Compliance Manual"). Although the Compliance Manual covers important areas, it does not describe the role of the CRO in compliance matters, nor does it describe the supervisory signoff process needed to close investigations and cases.

Recommendations

- The Exchange should take steps to ensure that the CSD is adequately staffed to meet OneChicago's self-regulatory responsibilities.
- The Compliance Manual should describe the role of the CRO in compliance matters and the supervisory signoff procedure required to close investigations and cases.

B. Trade Practice Surveillance Investigations and Cases

Findings

- There are three levels to OneChicago's trade practice surveillance and investigative process: (1) automated alerts, real-time reviews of trading activity conducted by the Director of Market Regulation (which are now conducted by the CRO), and Intermarket Surveillance Group ("ISG") email alerts; (2) investigations; and (3) cases.
- The Exchange maintains a record of its investigations in a database from which it can generate an "investigations log." If an investigation is not elevated to a case, the Exchange produces no additional documentation of the matter.
- There were 38,766 automated alerts, 653 ISG email alerts, and 71 investigations during the target period. With respect to the ISG alerts, 226 related to products traded on OneChicago. Only one ISG alert involved possible suspicious activity and this resulted

in Exchange staff commencing a case to investigate the matter, which closed without action.

- The Exchange maintains a case file for each case. The case file includes a case closing summary that describes the case and CSD staff's analysis and conclusions. During the target period, several case closing summaries were not signed by the Exchange staff member responsible for approving case closure, and most of the closing summaries that were signed did not include a signature date. In addition to the case files, the Exchange maintains a case log indicating the general subject matter of the case, the Exchange rules at issue, and the closing date. No cases during the target period were referred to the disciplinary committee.
- OneChicago closed 12 cases during the target period. In one case where the Exchange found a rule violation, it sent a warning letter to the relevant clearing firm but not to the trading firm. In another case where the Exchange found a rule violation, there was not enough documentation in the case file concerning the market participants' intent to determine whether a warning letter was sufficient disciplinary action. Aside from those exceptions, the cases closed during the target period were thorough and well documented. In addition, they were all completed in a timely manner.

Recommendations

- The Exchange should ensure that each case closing summary include a dated CRO approval signature.
- When the Exchange identifies violations of its rules, the Exchange should take appropriate action against the market participant itself and not only third parties, such as the participant's clearing firm.
- The Exchange should document its investigation of a market participant's intent or lack of intent in violating an Exchange rule. Such record is necessary to allow the Division to assess the sufficiency of the Exchange's disciplinary action.

C. Trade Practice Surveillance Systems and Monitoring of Block and EFP Transactions

Findings

- The Exchange's electronic trade practice surveillance system, called Csystem, generates automated alerts of potential trade practice violations in near real-time and at the end of the day. Exchange staff also monitors trading activity in real-time and performs spot checks of block trades and exchange of future for physical ("EFP") transactions.⁵

⁵ Real-time reviews consist of *ad hoc* monitoring performed by the CSD and other staff when unusual trading activity, spikes in volume, or other circumstances warrant special monitoring of one or more trades or trading accounts.

- There were seven spot checks of EFP transactions during the target period. During the target period, EFP transactions accounted for approximately 15 percent of the Exchange's total volume.
- There were three spot checks of block trades during the target period. All three spot checks took place in two consecutive months near the end of the target period. During the target period, block trades accounted for over 75 percent of the Exchange's total volume.
- OneChicago's rulebook requires block trades to be reported to the Exchange "without delay." Its rulebook has no provisions for reporting EFPs to within a specific time frame. However, a post-target period Exchange notice to members provides that both off-exchange EFPs and block trades must be reported within five minutes of execution during normal market conditions. An earlier EFP procedures document available on OneChicago's website provides that EFPs must be reported to the Exchange within a reasonable period of time.
- Exchange staff allows block trades to be reported outside of the five minute time frame when the circumstances of a market participant make it difficult to report the trade within five minutes of execution.

Recommendations

- OneChicago's post-target period notice to members that requires off-exchange EFPs to be reported within five minutes of execution conflicts with an earlier EFP procedures document on the Exchange's website which provides that EFPs must be reported to the Exchange within a reasonable period of time. The Exchange should rectify this conflict and make clear to market participants the specific time frame within which an EFP must be reported.
- OneChicago should clearly enumerate in its rules, guidance, or notices to market participants any exceptions to the Exchange's requirement that off-exchange EFP and block transactions be reported within a specified time frame.
- The Exchange should significantly increase the frequency and number of spot checks of EFP and block transactions that it conducts annually.
- While increasing the frequency and number of EFP and block trade spot checks, the Exchange should also strategically select the EFP and block transactions it reviews so as to better detect misconduct.

D. Trade Adjustments and Cancellations

Findings

- The Exchange has an error trade policy governing trade modifications and cancellations that provides a “no bust” range applicable to both on- and off-exchange transactions. However, during the target period the Exchange modified or cancelled 14 transactions (consisting of both on- and off-exchange transactions) that were within the no-bust range.

Recommendation

- The Exchange’s written trade modification and cancellation policies should be consistent with the criteria actually used to determine whether it will cancel or modify transactions.

IV. OVERVIEW OF ONECHICAGO

A. Exchange Organization

OneChicago was designated as a contract market on June 12, 2002, and began trading security futures products on November 8, 2002. The Exchange was initially a joint venture of the Chicago Mercantile Exchange, Inc. (“CME”), the Chicago Board Options Exchange (“CBOE”) and the Chicago Board of Trade (“CBOT”). In 2006, Interactive Brokers Group, LLC (“Interactive Brokers”) bought approximately 40 percent of OneChicago.⁶ In addition to owning equity in OneChicago, Interactive Brokers is a OneChicago market participant. CME (23 percent), CBOE (23 percent) and CBOT (5 percent) remain as the other major owners. OneChicago trades are cleared by the Options Clearing Corporation (“OCC”). Firms that are approved to clear single stock futures at OCC are qualified to trade for themselves and for customers at OneChicago.

B. Security Futures Products

At the close of the target period, OneChicago offered approximately 2,800 security futures products. “OCX.Original” is OneChicago’s original single stock futures product. It is an agreement to deliver 100 shares of a specific equity at a designated date in the future. The underlying equity of the stock futures product can consist of a single common stock or other types of equities. In October 2010, OneChicago launched the “OCX.NoDivRisk” product, a variant of the OCX.Original product that eliminates dividend risk.⁷ OneChicago also offers

⁶ Interactive Brokers is entitled to a percentage of OneChicago’s profits and, pursuant to OneChicago Rule 207(b)(iii), Interactive Brokers appoints two out of OneChicago’s eight directors.

⁷ Dividend risk is eliminated because OCX.NoDivRisk products do not have dividend distribution expectations priced into the contract.

futures in narrow based index products (“NBIs”), although no NBI products were traded during the target period.⁸

During the target period, the Exchange’s trading volume totaled 4,451,038 contracts (comprising a total of 75,896 transactions), with a monthly average volume of approximately 370,919 contracts. Volume ranged from a low of 115,974 contracts in July 2011 to a high of 868,512 contracts in June 2012. Block trades accounted for 3,419,851 contracts (comprising a total of 2,071 trades), which is over 75 percent of the Exchange’s volume during the target period. EFP transactions accounted for 668,975 contracts (comprising a total of 10,722 trades), which is approximately 15 percent of the Exchange’s volume during the target period.

During the 2013 calendar year, the Exchange’s trading volume totaled 9,515,194 contracts, comprising a total of 74,707 transactions. Block trades accounted for 8,798,252 contracts (13,484 transactions), representing approximately 92 percent of the Exchange’s volume in 2013. EFPs accounted for 383,223 contracts (1,442 transactions), representing approximately 4 percent of the Exchange’s volume in 2013.

C. Membership

To trade at OneChicago, a market participant must be approved to clear single stock futures at OCC or arrange to trade through a firm approved to clear single stock futures at OCC. Exchange rules require each of OneChicago’s members, including clearing members, to designate at least one employee or agent as a “Responsible Trader” regarding that member’s use of the Exchange’s system. Such individuals are responsible for any and all communications

⁸ NBIs are cash settled futures on custom indexes comprised of up to nine underlying equity names created at the customer’s request.

between the member and OneChicago, and notices sent to Responsible Traders by the Exchange are binding upon the member.⁹

D. Trading Systems

OneChicago offers two trading platforms: (1) *CBOEdirect*; and (2) OCX.BETS®. All non-block and non-EFP transactions are executed electronically on *CBOEdirect*. *CBOEdirect* is operated by CBOE in accordance with a matching services agreement. Among other things, this agreement requires that CBOE provide technological services to OneChicago necessary to match trades, generate trade records and other market data reports, receive quotes and orders, and submit matched trades and related data to OCC. CBOE also is contractually obligated to resolve and troubleshoot problems and to maintain specific levels of capacity and service.

OCX.BETS is the Exchange's proprietary block and EFP platform. For "on exchange" block and EFP transactions, OCX.BETS is used to both execute and report transactions. In particular, OCX.BETS displays all orders to all market participants and allows blocks and EFPs to be competitively traded. Off-exchange blocks and EFPs are only reported on OCX.BETS. An EFP transaction at OneChicago is an order to buy (or sell) an amount of an underlying equity and simultaneously sell (or buy) the proportionate number of futures on that underlying equity. With respect to EFPs executed on OCX.BETS, the contracts are quoted on OCX.BETS as the difference in price between the underlying security and the future. OneChicago reports the stock leg execution to the Financial Industry Regulatory Authority ("FINRA")/NASDAQ Trade Reporting Facility ("FINRA/NASDAQ Trade Reporting Facility") and sends the futures transaction to CBOE for reporting and to OCC for clearing. EFP transactions are discussed in detail in section VI.A below.

⁹ See OneChicago Rule 513(a).

E. Market Maker

OneChicago has a market maker program but market makers receive no benefits from participating in the program.¹⁰ Given that there are no benefits or trading incentives associated with being a OneChicago market maker, there is no heightened surveillance for market makers as compared to other market participants.

Three firms are market makers on the Exchange. One of those market makers is owned by Interactive Brokers, which, as explained above, owns part of OneChicago. The Exchange explained to the Division that potential trading violations by Interactive Brokers are treated the same way as potential violations as other market participants. In its review of the Exchange's cases, the Division found that the Exchange conducted spot checks of EFP transactions entered into by the market maker owned by Interactive Brokers. The Division also found that cases during the target period included cases where the transactions at issue were entered into by Interactive Brokers customers.

V. COMPLIANCE SURVEILLANCE DEPARTMENT AND THE ROC

A. Compliance Surveillance Department

On June 1, 2010, OneChicago took over the regulatory functions previously provided by CME. Within OneChicago, trade practice surveillance is conducted by the Compliance Surveillance Department. The CSD consists of three positions: the CRO, the Director of Market Regulation, and the Market Regulation Analyst.

¹⁰ See OneChicago Rule 514 (Market Maker Programs), OneChicago Rule 515 (Customer Margin Requirements – General Requirements; Offsetting Positions; Exclusion for Market Makers), and the OneChicago Market Maker Registration Policy and Procedures.

1. CSD Staffing

Although it is a critical position, OneChicago operated without a CRO between January 2011 and November 2013, when a new CRO was named. The Division notes that for approximately four months in early 2013 (until his departure in April 2013), the Director of Market Regulation was appointed “Acting CRO.” Under Exchange rules, the CRO oversees compliance matters and manages the day-to-day regulatory functions of the Exchange.¹¹ Further information regarding the Exchange’s new CRO is found below.

During the target period, OneChicago’s Chief Operating Officer (“COO”) performed certain compliance tasks in lieu of the CRO. These tasks included reviewing Csystem alerts with the chief executive officer (“CEO”) to make sure that they were appropriately addressed, meeting with the Director of Market Regulation to determine whether to elevate an investigation to a case, and signing off on closure of a case before the report was sent to the ROC. Prior to joining OneChicago in 2008, the COO worked in the regulatory and operations divisions of a major futures exchange for 23 years. His last position at that exchange was as vice-president of trading operations.

The Director of Market Regulation is responsible for conducting investigations and cases, interfacing with the ROC, providing regulatory guidance to market participants, and representing OneChicago in industry groups and in discussions with the SEC and CFTC. The individual who served as the Director of Market Regulation during the target period joined OneChicago in November 2002. Up until 2010, he supervised the Exchange’s customer support division. Prior to joining OneChicago, he worked at a futures brokerage firm between 1983 and 1998, first as a desk supervisor, then as an operations manager, and finally as director of trading operations.

¹¹ See OneChicago Rule 208(f).

In April 2013 (after the end of the target period), the Director of Market Regulation left the Exchange and, in June 2013, the Exchange hired a new Director of Market Regulation. The newly hired individual was a 2013 law school graduate who worked for nine months during law school as a regulatory analyst at FINRA and participated in the Summer Honors Law Program with the U.S. Securities and Exchange Commission in the Office of Compliance Inspections and Examinations. While there is no indication that the Director of Market Regulation was unable to fulfill his responsibilities, the Division was concerned that the Exchange would appoint a relatively inexperienced Director of Market Regulation and discussed this with the Exchange.

In November 2013, the Director of Market Regulation became the CRO after being in the Director of Market Regulation position for approximately six months. This left the Director of Market Regulation position vacant. The Division is concerned by the CRO's relative inexperience and the lack of a Director of Market Regulation. These factors may place strain on the CSD's ability to perform its daily surveillance activities and fulfill the Exchange's self-regulatory responsibilities. In addition, the Division notes the recent increases in Exchange trading volumes outlined above. The Division believes that the Exchange should take steps to ensure that the CSD is adequately staffed to meet OneChicago's self-regulatory responsibilities.¹²

Finally, the Exchange hired a consultant to work on regulatory and compliance matters during its search to fill the Director of Market Regulation position. The Exchange continues to engage the services of this consultant on part-time basis.

¹² The Division notes that DCMs have been required to comply with Commission Regulation 38.155 since October 17, 2012. Regulation 38.155 requires that a DCM monitor the size and workload of its compliance staff annually and ensure that its compliance resources are at appropriate levels. A review of the appropriate level of compliance resources and staff should consider trading volume increases.

In addition to the CRO and the vacant Director of Market Regulation position (and currently, the part-time regulatory and compliance consultant), the CSD includes a Market Regulation Analyst. The Market Regulation Analyst investigates changes in open interest by clearing firms that did not have any associated trading volume the previous day, obtains large trader position data, collects and maintains CFTC Form 102s, reviews all ISG email alerts,¹³ and addresses all intraday trading alerts. The Market Regulation Analyst worked as the Exchange's technology and operations coordinator between 2002 and 2010. Prior to joining OneChicago, he worked at a major futures exchange between 1979 and 2000, and between 2000 and 2002 he managed the IT/operations department for a financial investments advisory firm.

Recommendation:

- **The Exchange should take steps to ensure that the CSD is adequately staffed to meet OneChicago's self-regulatory responsibilities.**

2. CSD Compliance Manual

The CSD did not have a formal compliance manual during the target period. The Exchange shared a draft compliance manual with the Division in March 2010, but that manual was never finalized. After the end of the target period, on January 29, 2013, the Exchange finalized the Compliance Manual. The Compliance Manual covers important areas including: automated tools such as Csystem; position limit and expiration procedures; position accountability reviews; ISG referrals and insider trading review procedures; the audit trail program, and EFP and block trade spot check procedures. The section on Csystem alerts

¹³ ISG is a membership organization created in 1983 by the major U.S. securities exchanges to share information regarding securities-related products. The "affiliate" category of ISG membership was created in 1990 to allow participation by futures exchanges and non-U.S. exchanges. ISG participation requires an agreement to share information concerning related products for the purpose of conducting routine surveillance, and to otherwise coordinate investigative efforts, including those involving potential inter-market violations, such as frontrunning and insider trading.

describes the circumstances under which an alert would be dismissed or an investigation opened. The insider trading review and spot check review sections describe when such reviews occur and the documentation considered during such reviews. However, the Compliance Manual does not describe the role of the CRO in compliance matters.¹⁴ In addition, the Compliance Manual does not describe the supervisory signoff process needed to close investigations and cases. The Division believes that exchange compliance manuals should reflect actual practices and procedures followed by compliance staff in their daily work.

Recommendation:

- **The Compliance Manual should describe the role of the CRO in compliance matters and the supervisory signoff procedure required to close investigations and cases.**

B. The ROC

The ROC oversees OneChicago's compliance and surveillance program. It monitors the sufficiency and effectiveness of the Exchange's regulatory program; reviews the size and allocation of the regulatory budget; reviews the number, hiring and termination, and compensation of regulatory personnel; supervises the CRO; prepares an annual report assessing the Exchange's self-regulatory program for the board of directors and the CFTC; and reviews regulatory proposals and advises the Board as to whether and how such changes may impact regulation. During the target period, the ROC met five times.

OneChicago's ROC was formed in February 2010, shortly before OneChicago took over compliance/surveillance functionalities from CME. Each of the ROC's three directors must be a "public director," as defined in the acceptable practices for Core Principle 16 (*i.e.*, no

¹⁴ See OneChicago Rule 208(f) (providing that the CRO oversees compliance matters and manages the day-to-day regulatory functions of the Exchange).

relationship with the Exchange that reasonably could affect the independent judgment of the director).¹⁵ The CSD's budget is prepared by the CEO, who reviews it with the ROC and then presents it to the board of directors. The CEO is the advocate for the budget before the ROC and, to date, the CSD has always received the amount requested. The Division notes that OneChicago's allocation of funds for regulatory purposes is greater than the allocation that was made during the pre-June 2010 time period when CME performed compliance functions.

VI. OVERVIEW OF EXCHANGE OF FUTURE FOR PHYSICAL TRANSACTIONS AND BLOCK TRADES AT ONECHICAGO

EFP and block transactions constituted a significant percentage of OneChicago's trading volume during the target period. Specifically, block trades and EFPs together comprised 90 percent of Exchange trading volume, with block trades accounting for 75 percent and EFPs accounting for 15 percent. The Exchange's block trade and EFP systems and practices are described in detail immediately below. The Exchange's surveillance of such transactions is discussed in detail in section VII.C.2.

A. EFP Transactions

An EFP transaction at OneChicago is an order to buy (or sell) an amount of an underlying equity and simultaneously sell (or buy) the proportionate number of futures on that underlying equity. Each futures product listed at OneChicago can be traded as the component of an EFP transaction. OneChicago Rule 416 authorizes EFP transactions and requires that a *bona fide* EFP contain the following elements:

¹⁵ See OneChicago Rules 207(n) (defining public director in a manner consistent with CFTC regulations) and 207(o)(i) (describing requirements for ROC membership).

- (1) The futures transaction and the transaction in the underlying security must be integrally related;
- (2) The exchange of futures for the underlying security must provide for the transfer of ownership of such security to the cash buyer upon performance of the terms of such futures, with delivery to take place within a reasonable time thereafter, in accordance with prevailing cash market practice; and
- (3) Separate parties are required on each side of the transaction, such that the accounts involved on each side of the EFP have different beneficial ownership or are under separate control.

In addition, each market participant involved in an EFP must maintain records evidencing compliance with these criteria and provide the documentation to the Exchange upon request.¹⁶ The minimum size for an EFP transaction is one futures contract and 100 shares of the underlying stock.

As explained by Exchange staff during the on-site interview, the Exchange characterizes its EFPs as the economic equivalent to securities lending and equity repo transactions, in the sense that securities lending and equity repo transactions are the secured lending of stock for cash or the lending of cash for collateral in the form of stock. Similarly, in an EFP, a stock owner “lends” stock by purchasing futures and selling the underlying security. The stock is returned when the owner sells the EFP or holds the futures to expiration.

As noted above, the Exchange’s rules provide that EFPs can be both executed and reported on OCX.BETS, or executed as off-exchange transactions and only reported on OCX.BETS. With respect to EFPs executed on OCX.BETS, the contracts are quoted on OCX.BETS as the difference in price between the underlying security and the future. OCX.BETS matches EFPs in price/time priority. An Exchange algorithm selects a stock price based on the current national best bid/offer and adds the EFP price to the selected stock price to

¹⁶ See OneChicago Rule 416(d).

determine the futures price. With respect to EFP reporting, OCX.BETS sends trade data to OneChicago's CBOE*direct* platform, which disseminates data for the futures leg and sends data on the stock leg to the FINRA/NASDAQ Trade Reporting Facility. The FINRA/NASDAQ Trade Reporting Facility is an automated trade reporting and reconciliation service that electronically facilitates trade reporting, trade comparison and clearing of trades for all U.S. equities. With respect to clearing, CBOE*direct* sends the futures leg to OCC and the FINRA/NASDAQ Trade Reporting Facility sends the stock leg to DTCC.

Where the transaction is an off-exchange EFP that is only reported on OCX.BETS, one party submits the EFP as an off-exchange transaction to the OCX.BETS platform and the opposite party accepts the trade on OCX.BETS. The futures transaction is sent to CBOE for reporting and to OCC for clearing. The stock portion of an off-exchange EFP is handled between the two parties to the trade through an executing or reporting venue outside of OCX.BETS and OneChicago. Exchange staff explained that during the target period, off-exchange EFPs were expected to be reported to OneChicago within five minutes of the transaction being completed by the parties during normal market conditions. A post-target period notice to members provides that off-exchange EFPs must be reported to the Exchange within five minutes of execution during normal market conditions. However, an earlier EFP procedures document available on OneChicago's website provides that EFPs must be reported to the Exchange within a reasonable period of time.

The Exchange's surveillance of EFP transactions is discussed in detail in section VII.C.2 below.

B. Block Trades

During the target period, OneChicago permitted block trades for a minimum of 100 contracts per transaction. After the end of the target period, effective on September 25, 2012, the Exchange amended its rules to reduce minimum block size to 25 contracts.¹⁷

As noted above, block transactions can be executed on OCX.BETS or reported to OCX.BETS as off-exchange transactions. With respect to block transactions executed on OCX.BETS, blocks are anonymously quoted and traded at the single stock future price. OCX.BETS will match bids and offers on a price time priority basis.

OneChicago Rule 417(c) requires that when a transaction is an off-exchange block transaction that is only reported on OCX.BETS, information identifying the relevant contract, contract month, price, quantity, time of execution, and the counterparty must be reported to OneChicago “without delay.” Exchange staff explained that during the target period, without delay meant that block trades were expected to be entered into OCX.BETS within five minutes of execution, and the counterparty is expected to accept the trade within five minutes of it being entered in OCX.BETS.¹⁸ The Exchange further explained that it allows block transactions to be reported outside of this timeframe where the circumstances of a market participant make it difficult to report the trade within five minutes; for example, where the market participant is executing multiple block trades at the same time.

The Exchange’s surveillance of block transactions is discussed in detail in section VI.C.2 below.

¹⁷ See OneChicago Rule 417(a). Exchange staff explained that the block size was lowered pursuant to self-certified rule in September 2012. The Exchange’s rule filing included statistics demonstrating that in 2011, less than 1% of regular central order book trades were for 25 contracts or greater, and in 2012, only 1.5% of central order book trades were for 25 contracts or greater.

¹⁸ A post-target period notice to members provides that off-exchange block trades must be reported to OneChicago within five minutes of execution.

Recommendation:

- **OneChicago’s post-target period notice to members that requires off-exchange EFPs to be reported within five minutes of execution conflicts with an earlier EFP procedures document on the Exchange’s website which provides that EFPs must be reported to the Exchange within a reasonable period of time. The Exchange should rectify this conflict and make clear to market participants the specific time frame within which an EFP must be reported.**
- **OneChicago should clearly enumerate in its rules, guidance, or notices to market participants any exceptions to the Exchange’s requirement that off-exchange EFP and block transactions be reported within a specified time frame.**

VII. TRADE PRACTICE SURVEILLANCE PROGRAM

Core Principle 2 – Compliance with Rules

- A. **IN GENERAL** – The board of trade shall establish, monitor, and enforce compliance with the rules of the contract market, including-
 - i. access requirements
 - ii. the terms and conditions of any contracts to be traded on the contract market; and
 - iii. rules prohibiting abusive trade practices on the contract market.
- B. **CAPACITY OF CONTRACT MARKET** – The board of trade shall have the capacity to detect, investigate, and apply appropriate sanctions to any person that violates any rule of the contract market.
- C. **REQUIREMENT OF RULES** – The rules of the contract market shall provide the board of trade with the ability and authority to obtain any necessary information to perform any function described in this subsection, including the capacity to carry out such international information-sharing agreements as the Commission may require.

Core Principle 12 – Protection of Markets and Market Participants

The board of trade shall establish and enforce rules

- A. to protect markets and market participants from abusive practices committed by any party, including abusive practices committed by a party acting as an agent for a participant; and
- B. to promote fair and equitable trading on the contract market.

During the entirety of the target period, Appendix B to Part 38 of the Commission’s regulations provided that a contract market’s trade practice surveillance program should have the

arrangements, resources, and authority necessary to perform effective rule enforcement.¹⁹ The arrangements and resources attendant to the program should facilitate the direct supervision of the contract market, including analysis of relevant data. Trade practice surveillance programs can be carried out by the contract market itself or through delegation to a third party.

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

A. Automated Surveillance System

"Csystem" is OneChicago's automated trade practice surveillance system used to identify possible trade practice violations on CBOE*direct* and OCX.BETS. Csystem was built in-house at the Exchange and began operating in June 2010, when the Exchange took over compliance functions from CME. Csystem generates alerts for potential trade practice violations every five minutes or on a daily basis, depending on the type of alert. The CSD seeks to address all outstanding alerts by the close of business each day.

¹⁹ 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 2 and 12, adopted rules, some of which codified previous guidance and acceptable practices. Because these rules were not effective during the target period, the Division evaluated the Exchanges' trade practice surveillance program pursuant to the substantive standards contained in the pre-existing guidance and acceptable practices.

Csystem generates the following automated alerts of potential trade practice violations.

Unless otherwise indicated, these alerts are generated every five minutes.²⁰

- (i) **Subaccount (or Customer Account)²¹ Wash Alert.** Generated when the same customer account is on both sides of the trade. There were 344 Wash Alerts during the target period, resulting in nine investigations.
- (ii) **Cross Time Warning.** Generated where the buyer and seller have the same CBOE*direct* login ID or where the same customer account is on both sides of the transaction, and the order times of the trade were less than a specified number of seconds apart.²² Csystem generates this type of alert on a daily basis. There were 2,647 Cross Time Warnings during the target period, resulting in three investigations.
- (iii) **Trade Price Alert.** Generated when a contract trades at more than a specified percentage away from the previous day's settlement price.²³ There were 5,210 Trade Price Alerts during the target period, resulting in eight investigations.
- (iv) **Stock Up or Stock Down Alerts.²⁴** Generated when the price of an underlying security moves beyond a set parameter. These alerts are used to identify potential inter-market frontrunning. There were 10,212 Stock Up alerts and 12,722 Stock Down alerts during the target period, resulting in eight investigations.
- (v) **POI (Person of Interest) Trade.** Csystem generates this alert when a particular customer account trades and the CSD staff has flagged that account as requiring heightened surveillance. There were 456 POI Trade alerts during the target period, resulting in one investigation.²⁵
- (vi) **OI Change Warning.** Csystem generates this alert when there are changes in open interest absent corresponding volume in the product. Csystem generates this

²⁰ The process of elevating an alert to investigation status is discussed in section VII.D.1 below. Exchange staff confirmed at the RER interview that staff reviews and takes affirmative action with respect to every alert.

²¹ A "subaccount" at OneChicago is a customer account, and further references to such accounts will use the term "customer account."

²² See OneChicago Notice to Members #2010-13 Re: Block Trades, Pre-Execution Discussions and Cross-Trades; OneChicago Rules 409 and 610 (requiring that a period of four seconds must elapse between entry of the initial order for a trade and entry of the order for the opposite side of the trade).

²³ See OneChicago Rules 601 (Fraudulent Acts); 603 (Market Manipulation); and 608 (Acts Detrimental to the Exchange). This surveillance function concerns insider trading, which is discussed in more detail in section VII.B below.

²⁴ See *id.* Similar to the Trade Price alert, the Stock Up and Stock Down alerts are intended to identify potential insider trading activity.

²⁵ This investigation had 31 corresponding entries on the investigation log because a new Csystem alert was generated each time the relevant account traded.

type of alert on a daily basis. There were 4,458 OI Change Warning alerts during the target period, resulting in eight investigations.²⁶

As noted above, in November 2013, the Director of Market Regulation became the CRO, and the Director of Market Regulation position became vacant. In this section and following sections, any work described as being performed by the Director of Market Regulation during the target period is now being performed by the CRO. In addition, the compliance tasks performed by the COO are being transitioned to the CRO.

During the target period, the above System alerts were typically reviewed by the Director of Market Regulation or the Market Regulation Analyst, and dismissed by either one. All new alerts are reviewed daily, and alerts also may be reviewed as necessary by the CEO and the COO. Csystem monitors all Exchange products regardless of the amount of trading activity or open interest. Alerts that are based on price movement in the underlying security (*i.e.*, the Stock Up and Stock Down alerts), as well as Wash Alerts, are typically mass dismissed by the CSD if the transactions triggering the alerts do not meet minimum thresholds of open interest and volume.

All Csystem alerts are recorded in a database and viewable on an exception screen that provides data for the alert, including the type of alert, the trade date and time, the account number, and a status column reflecting whether the alert has been dismissed. Csystem also displays an exception summary report that shows alerts by type, total number of alerts, total number of alerts reviewed by particular Csystem users, how many investigations have been requested and how many of those are still active. During the target period, the Director of

²⁶ Although they are irrelevant for purposes of this rule enforcement review, it should be noted that Csystem also generates Position Limit Warnings, Missing 102B Warnings, and Position versus LTR Warnings. There were 2,717 such alerts during the target period, resulting in one investigation.

Market Regulation sent a snapshot of the exception summary page to the ROC on a monthly basis.²⁷

B. Insider Trading Surveillance

The Exchange conducts insider trading surveillance through several of the above-listed Csystem alerts (including Stock Up, Stock Down, and Trade Price Alerts). In determining whether to elevate an alert to investigation status, Exchange staff will look at the trading activity preceding significant moves in the underlying security and review news sources to determine if there is company news that warranted the activity. If a matter is isolated for further review, account statements may be collected from the clearing firm in order to further assess whether there has been insider trading. A full case will be opened if there is a reasonable basis to believe that someone has acted on inside information.

In addition to Csystem, the Exchange monitors insider trading through ISG alerts. Whenever a new ISG investigation is opened, OneChicago receives an email alert. During the target period, the Director of Market Regulation reviewed each such ISG alert, checked for OneChicago activity relating to the ISG alert and determined if OneChicago should join the investigation.²⁸ There were 653 ISG email alerts during the target period, 226 of which related to products traded on OneChicago. There was one investigation resulting from an ISG alert initiated during the target period, and this investigation resulted in a formal case that closed without action.

²⁷ The Exchange's regulatory and compliance consultant has sent the monthly Csystem summaries to the ROC since the departure of the Director of Market Regulation in April 2013.

²⁸ As noted above, since November 2013, the CRO performs tasks previously performed by the Director of Market Regulation.

C. Non-Automated Trade Practice Surveillance

1. Real-Time Monitoring of Trading Activities

In addition to automated trade practice surveillance, the CSD conducts real-time monitoring of Exchange trading activities. During the target period, the Director of Market Regulation and staff in the Exchange's operations group monitored for any unusual trading activity, including unusual volume in a product, unusual volume by a customer account, or a new customer account with a high level of activity.²⁹ There was no set schedule for conducting these reviews. Since November 2013, the CRO has performed the real-time monitoring tasks previously performed by the Director of Market Regulation.

2. EFP and Block Trade Surveillance

The Exchange's trade practice surveillance program includes reviews of EFP and block transactions for compliance with OneChicago Rule 416 (Exchange of Future for Physical) and OneChicago Rule 417 (Block Trading). In addition to the Csystem alerts, insider trading tools and non-automated surveillance activities described above, the Exchange monitors on- and off-exchange EFP and block transactions with electronic tools called "Ad Hoc Query" and the "Green Screen." The Ad Hoc Query is a search tool and the Green Screen displays volume and product data for the current day. Compliance and operations staff use these tools to analyze the volume, frequency of participation and nature of EFP and block trade transactions. For example, Exchange staff will review data to determine if a market participant is trading an EFP or a block transaction for the first time, or for the first time in an unusual size, or if a market participant's EFP or block transaction is based on a different underlying security than what it normally trades.

²⁹ The Exchange's operations group is supervised by the COO and is responsible for real-time monitoring of trading activity. Aside from the COO, there is one other individual in the operations group. In addition, there is an employee outside of the operations group who primarily works with the Exchange's customers, but is available to perform real-time monitoring functions as a backup when needed.

For block trades, the Exchange also will use an automated price check program called the Price Check Monitor to highlight block trades that trade at a certain predetermined amount above or below the current market price of the underlying securities.³⁰ The Exchange will review the trade details, future and stock quotes, and the underlying price movements for such trades to determine whether there is any potential rule violation.³¹

In addition, approximately once per month the Exchange will conduct a spot check of an on- or off-exchange EFP or block transaction. Spot checks of EFPs and block transactions are automatically opened as cases.³² There were seven EFP spot check cases open during the target period (two were for EFPs executed on OCX.BETS and five were for off-exchange EFPs). There were three block trade spot check cases opened during the target period, which were opened in the consecutive months of April and May 2012.³³ All spot check cases were closed without action. Transactions are chosen to be spot checked for various reasons, including that the trading entity was a new market participant, or one that had not traded for a while, or because there had been unusual trading around a news event.

In an EFP spot check, the CSD requests from both trade participants documentation evidencing ownership, account statements evidencing the stock and futures portions of the EFP trade, and related trade tickets and trade confirmations. The CSD will review the documentation to confirm that both the futures and the stock legs were executed for the same customers, that the

³⁰ This price check program was launched on January 24, 2012, approximately halfway through the target period. Prior to that date, all block trades were reviewed manually in real-time by Exchange personnel.

³¹ During the target period, there were 192 trades highlighted for review by the Price Check Monitor, none of which resulted in investigations or cases.

³² As explained in Section VII.D.1, cases include: investigations involving activity that could constitute a violation of Exchange rules; block trade and EFP transaction spot checks; customer complaints; and CFTC referrals.

³³ These block trade spot check cases remained open and pending at the end of the target period. The Exchange confirmed that each of these cases closed without any action by the Exchange.

stock is related to the future, and that the customers have been informed of fees charged by brokers. In a block trade spot check, the CSD requests from both sides of the transaction account documentation evidencing ownership, account statements and related trade tickets, audit trail and trade confirmations. The CSD then reviews the documentation to confirm that the trade allocation, trade price negotiations, and trade reporting time are consistent with Rule 417.

The Division is concerned by the small number of block and EFP spot checks that were performed during the target period. As noted above, there were 2,071 block transaction during the target period, accounting over 75 percent of the Exchange's volume. There were 10,722 EFP transactions during the target period, accounting for approximately 15 percent of the Exchange's volume. The Division believes that three block transaction spot checks and seven EFP transaction spot checks during the target period is insufficient given the amount of overall volume that such transactions represent at the Exchange. Accordingly, the Division believes that the Exchange should significantly increase the frequency and number of EFP and block transaction spot checks. In addition, while the Exchange should continue to select transactions to spot check pursuant to the factors it used during the target period, it should also choose more block and EFP transactions with an eye to detecting potentially violative transactions. For example, the types of EFP transactions that the Exchange should consider for spot check should include, without limitation: (i) transactions in an unusual number of contracts; (ii) EFP transactions just below the respective block size threshold; (iii) EFP transactions between affiliates; and (iv) transactions by parties that conduct a large number of EFP transactions or that execute offsetting EFP transactions on the same day. Reviews of block transactions should also consider factors that could indicate potentially violative activity.

Recommendations:

- **The Exchange should significantly increase the frequency and number of spot checks of EFP and block transactions that it conducts annually.**
- **While increasing the frequency and number of EFP and block trade spot checks, the Exchange should also strategically select the EFP and block transactions it reviews so as to better detect misconduct.**

D. Trade Practice Investigations Process

1. Overview

There are three levels to OneChicago's trade practice surveillance and investigative process: (1) automated alerts; real-time reviews of trading activity and other reviews conducted by the Director of Market Regulation (now conducted by the CRO); and ISG email alerts; (2) investigations; and (3) cases. The initial stage of the investigation process consists of the Csystem alerts and ISG email alerts. If an alert requires additional review in order to make a reasonable judgment as to the possibility of suspicious activity, the alert transitions to "investigation" status. Anyone at the Exchange with access to Csystem (excluding IT support) can elevate an alert to an investigation, although during the target period it would typically be the Director of Market Regulation or the Market Regulation Analyst. The Exchange maintains a log of investigations triggered by Csystem alerts and ISG email alerts, but it does not maintain further documentation for investigations other than the investigations log.

Once the Director of Market Regulation collected evidence and conducted an initial investigation, he would meet with the COO and determine what additional steps to take. If the activity could constitute a violation of OneChicago rules, the Director of Market Regulation transitioned the matter from status as an "investigation" to a "case." If the Director of Market Regulation determined that the investigation should be dismissed, he would briefly describe the reason for dismissal in the investigations log. The Director of Market Regulation did not need

supervisory sign-off in order to dismiss an investigation. Given the promotion of the Director of Market Regulation to CRO, the CRO now performs the above-described tasks previously performed by the Director of Market Regulation.

In addition to investigations that involved activity that could constitute a violation of Exchange rules, cases also include block trade and EFP transaction spot checks, customer complaints and CFTC referrals. Spot checks, customer complaints and CFTC referrals are initially opened as cases, rather than as investigations. With respect to cases, CSD staff documents all correspondence to and from the parties to the trade activity under review, and maintains an activity log for each formal case. During the target period, the Director of Market Regulation would handle cases and prepare a report to the ROC containing the CSD's analysis and recommendation. The COO would sign off on case closures. In April 2013, when the Director of Market Regulation departed, the Exchange retained a regulatory and compliance consultant and this consultant prepared case reports to the ROC. Since the hiring of the Director of Market Regulation in June 2013 and promotion of that individual to CRO, such tasks previously performed by the Director of Market Regulation, the consultant, and COO are being transitioned to the CRO.

2. Investigations and Cases During the Target Period

i. Investigations During the Target Period

As noted above, OneChicago maintains a record of its investigations in an investigations log. The investigation log maintained during the target period indicated the type of alert and status (*i.e.*, whether the investigation was dismissed or elevated to case status), and included notations concerning the nature of the investigation and why it was dismissed. The initial version of the investigations log produced to the Division did not include the date that the

investigation was opened. However, this information was available on the Exchange's system and was submitted to the Division upon request.

There are 71 investigations during the target period. Thirty-two (32) of those investigations concerned alerts (consisting of POI alerts and a Trade Price alert) that ultimately were elevated to become Case No. 2012-07.³⁴ Other investigations resulted from: ISG email alerts (1);³⁵ Cross Time and Wash Alerts (14); Stock Up, Stock Down, and Trade Price alerts (15); and Open Interest Change alerts (8). The remaining investigation resulted from a Position versus Large Trade Report warning (1).

ii. Cases During the Target Period

There were 20 open cases at the Exchange during the target period. They were triggered by the following:

- Two cases were opened as a result of external referrals: a CFTC referral and an anonymous customer complaint;
- One case was opened as a result of an ISG email alert;
- Three cases were generated from automated Csystem trade practice alerts (these were Wash, Trade Price, and POI alerts);
- Four cases were opened as a result of staff non-automated surveillance;
- Seven cases were EFP spot checks; and
- Three cases were block trade allocation spot checks.

Out of those 20 cases, 19 were opened and 12 were closed during the target period. Information on timeliness of closure of cases is provided in section VII(D)(2)(iii).

³⁴ This case concerned potential money passes between related Interactive Brokers accounts held by several traders located in China. There were multiple entries on the investigation log because a new Csystem alert (almost all of which were POI alerts) was generated each time the accounts traded.

³⁵ There are two investigations listed on the investigations log as being initiated by ISG alerts; however, one of these entries was opened by the Exchange's IT department as a test of the Exchange's systems.

Out of the 12 cases closed during the target period, eight were closed without action. The four remaining cases resulted in warning or reminder letters, and no cases during the target period were referred to the disciplinary committee. All four cases resulting in warning or reminder letters are summarized below. The first case (concerning position limits) does not specifically relate to trade practice surveillance. However, it is included in the discussion below due to the limited number of cases that resulted in disciplinary action during the target period.

The first case resulting in a warning letter (Case 2011-03) involved a market participant's failure to acquire a position limit exemption, which resulted in a violation of OneChicago Rule 414 (Position Limits and Position Accountability).³⁶ Shortly before the violation occurred, the market participant and the Exchange communicated about position limits and the market participant verbally indicated to the Exchange that it would be applying for an exemption. However, the market participant did not formally apply for the exemption until three days after the violation occurred. The Exchange initiated a case to investigate the violation based on a CFTC inquiry and its own awareness that a violation occurred. The position limits exemption application, when submitted, satisfied Rule 414's requirements. This was the market participant's first exemption application and its first position limits violation. The Exchange issued a letter detailing the violation and warning that further violations could result in formal disciplinary action.

The second and third cases (Cases 2011-06 and 2011-07) involved cross trades in violation of Exchange rules requiring that a period of four seconds elapse between entry of the initial order for a trade and entry of the order for the opposite side of the trade by the same

³⁶ Rule 414(c) provides that an application for an exemption from position limits for hedging purposes may be made in accordance with certain requirements listed in that rule.

party.³⁷ In October 2011, the market participant conducted 14 cross trades in under four seconds and the Exchange opened Case No. 2011-06 to investigate this activity. In November 2011, while Case No. 2011-06 was still pending, the same market participant crossed orders in under four seconds on two more trades. The Exchange commenced Case No. 2011-07 concerning the November 2011 activity, and investigated Cases Nos. 2011-06 and 2011-07 at the same time. The Exchange became aware of the violations and initiated the cases as a result of the CSD's real-time monitoring of Exchange trading activities. The market participant asserted with respect to the 2011-06 trades that it believed that OCX.BETS would not allow cross trades to execute in under four seconds. The market participant asserted with respect to the 2011-07 trades that it believed that OCX.BETS malfunctioned. The Exchange found no evidence of a malfunction and issued a single warning letter to the market participant's clearing firm.

The Division is concerned that while a warning letter was sent to the clearing firm, no warning letter was sent to the market participant itself that conducted the cross trades. Where a market participant has violated exchange rules, such participant should be made aware of its violation and of its direct responsibility to comply with Exchange rules.³⁸

The remaining case resulting in a warning letter (Case 2012-03) concerned six off-exchange EFP transactions that were erroneously reported as block transactions. This case was opened as a result of an anonymous complaint. Two market participants entered into a series of block transactions, and the Exchange located corresponding stock trades listed on Bloomberg. The Exchange questioned the market participants and one acknowledged that the block trades

³⁷ See OneChicago Rules 409 and 610; OneChicago Notice to Members #2010-13 Re: Block Trades, Pre-Execution Discussions and Cross-Trades. In accordance with OneChicago Rules 409 and 610, participants may cross orders, where the participant enters one side of the trade and the participant's customer takes the other side.

³⁸ Between October 1, 2011 and January 31, 2012 (the cases' closing date), the market participant executed an additional 159 trades, all without any issues or violations.

were actually part of EFP transactions. The Exchange issued a reminder letter to both firms stating that EFP transactions must be designated as such and that further incorrect trade type designations could result in formal disciplinary action. The Exchange also issued a Notice to Members giving guidance to the trading community clarifying the distinction between EFP and block transactions. The Division notes that the case file contained a record of phone calls made by the Director of Market Regulation to the market participants, but this record did not indicate whether there was any inquiry by the Exchange into the market participants' intent or lack of intent in reporting the transactions as block transactions, rather than EFP transactions. Such a record is necessary for the Division to assess the sufficiency of the Exchange's disciplinary action.

Recommendations:

- **When the Exchange identifies violations of its rules, the Exchange should take appropriate action against the market participant itself and not only third parties, such as the participant's clearing firm.**
- **The Exchange should document its investigation of a market participant's intent or lack of intent in violating an Exchange rule. Such record is necessary to allow the Division to assess the sufficiency of the Exchange's disciplinary action.**

iii. Timeliness and Recordkeeping of Investigations and Cases

The Exchange closed target period investigations and cases in a timely manner. Out of the 71 target period investigations, 36 were closed within one month (approximately half of which were opened and closed on the same or next day), and three were closed within three months. The remaining 32 all related to the same matter, which were elevated to Case No. 2012-07, and were closed after the end of the target period approximately four months after the investigations were initially opened.

Each of the 12 cases that closed during the target period was closed within six months after it was opened. Out of those 12 cases, eight cases were closed within three months, and the remaining four closed within six months.

All cases, including those that were closed with no further action, included a closing summary that described the case and the CSD staff's analysis and conclusions. In addition to the case files, the Exchange maintained a case log indicating the general subject matter of the case, the Exchange rules at issue, and the closing date. There were three minor date discrepancies between the closing dates recorded on the case log and the closing dates recorded in the case files; however, the Exchange provided the Division with the correct closing dates of the cases.

The Division found that the Exchange's recordkeeping with respect to each of the cases closed during the target period was generally adequate, with two exceptions. The first is the lack of documentation concerning intent or lack of intent in violating an exchange rule, noted above with respect to Case 2012-13. In addition, the Division notes that several case closing summaries at the beginning of the target period were not signed by the COO, who at the time was responsible for approving closure of cases. In addition, most of the closing summaries that were signed by the COO did not include a signature date. A dated signature would enable the Exchange to more easily determine the source of any delays in the investigative process. Other than the foregoing, the case files were well-documented and included relevant trading documents and correspondence.

Finally, the Division notes that the case log produced by the Exchange did not include the date that a case was referred to the CRO. The Division has recommended in other rule enforcement reviews that case logs must include both the date on which each case was completed by staff, and also the date of CRO approval. Now that the Exchange has a CRO, the

Division would expect that the Exchange's case log will include the date a case is completed by staff and the date of CRO approval, to the extent that a case is handled by an individual other than the CRO. The case log should also include the date that a case was referred to a disciplinary committee, if applicable.

Recommendation:

- **The Exchange should ensure that each case closing summary include a dated CRO approval signature.**

E. Pauses and Halts

OneChicago rules provide that the Exchange will halt trading in a single stock future when there has been a regulatory halt instituted for the security underlying the single stock future.³⁹ The Exchange has also established guidelines providing that the Exchange may halt trading in the event of system failure of the *CBOEdirect* or OCX.BETS trading platforms, a lead market maker, or the CBOE Financial Network.⁴⁰ In addition to the foregoing rules and guidelines, the *CBOEdirect* platform halts trading automatically if there is a pause or halt on the underlying securities exchange. If *CBOEdirect* halts, OCX.BETS will not post a trade, which prevents EFPs or block trades from being fully consummated when the underlying market is in a regulatory halt.⁴¹ OneChicago notifies its trading community of the beginning and end of a pause or halt by email. There were a total of 152 pauses and halts for individual underlying securities on the Exchange during the target period. Each was triggered by the underlying

³⁹ See OneChicago Rule 419.

⁴⁰ The CBOE Financial Network is the market data supplier of OneChicago information to market data vendors. If its service was interrupted, OneChicago would be unable to disseminate market data.

⁴¹ Exchange staff explained during the RER interview that even if the parties agree on price and quantity, there is no trade until OCX.BETS confirms the trade.

exchange's decision to pause or halt trading in the underlying security. The Division does not have any recommendations in this area.

F. Trade Modifications and Cancellations

OneChicago has established an Error Trade Cancellation and Price Adjustment Policy ("Error Trade Policy"), under which the Exchange may adjust trade prices or cancel trades when allowing the trade to stand as executed may have a material, adverse effect on the integrity of the market.⁴² Under the Error Trade Policy, the following errors will not be considered for modification or cancellation: an error in entering a buy/sell when the intent was to enter a sell/buy; and an error caused by entering the wrong month, the wrong quantity or the wrong product. The Error Trade Policy also provides a "no bust" range and states that if the trade is inside the "no bust" range, the trade will stand unless there is a OneChicago system failure or rule violation.

During the onsite interview portion of this RER, OneChicago's staff stated that the Exchange will cancel trades inside the no bust range where the trade is made off-exchange and a mistake has been made, and that they are more guided by the no bust range in instances where the trade is electronic. Exchange staff indicated that the alternative would be to require the trade participants to execute a transaction that would essentially cancel the erroneous trade, and this would result in the Exchange reporting volume that does not actually exist.

OneChicago modified or cancelled 29 transactions during the target period.⁴³ Nine of the 29 modified transactions were within the "no bust" range of the Error Trade Policy, and five

⁴² See Error Trade Policy, available at http://www.onechicago.com/wp-content/uploads/content2010/error-trade-policy-efp-revision-06_2010cftc_finalpost.pdf. OneChicago Rule 418 provides that "[a]ny error trades shall be resolved in accordance with the policies and procedures from time to time adopted by the Exchange."

⁴³ OneChicago rejected eight trade modification or cancellation requests (this number excludes modification and cancellation requests where the transaction was clearly inside the no bust range).

were off-exchange transactions within the “no bust” range of the Error Trade Policy. Trades within the no bust range were modified or cancelled for reasons that include the following: A trader transposed the buyer and the seller; a trader entered an incorrect futures price based on incorrect hedge calculation (two such cancellations); a trader mistakenly traded with himself; a December-January block roll trade was mistakenly entered using December-March prices; a bid was mistakenly entered with a positive rather than a negative price (two such cancellations); and a trader mistakenly traded the wrong product (two such cancellations).

The Division is concerned by the Exchange’s failure to follow its own procedures concerning error trades (meaning, failing to adhere to its no bust range and modifying or cancelling trades where the error is entering the wrong month or the wrong product). The Division believes that the Exchange’s practices in this area should be consistent with its public guidelines so that market participants are aware of both their rights and obligations when trading on OneChicago. Toward that end, if the Exchange wishes to have exceptions to its no bust range for the cancellation of trades, such exceptions should be included in its Error Trade Policy.

Recommendation:

- **The Exchange’s written trade modification and cancellation policies should be consistent with the criteria actually used to determine whether it will cancel or modify transactions.**

VIII. CONCLUSION

The Division found that OneChicago's trade practice surveillance program provides for monitoring and investigation of potential trade practice violations, including through automated Csystem and ISG email alerts and other measures. However, the Division also believes that the Exchange would benefit from several enhancements to its existing program, including in the areas of staffing and more frequent EFP and block trade spot check reviews. In particular, the Division is concerned by the CRO's relative inexperience, the lack of a Director of Market Regulation, and the small number of EFP and block trade spot check reviews during the target period given the high percentage of Exchange trading that consists of EFP and block trades. Finally, the Division is concerned that the OneChicago does not always follow its own rules, policies or procedures when determining whether to modify or cancel trades.