

**RULE ENFORCEMENT REVIEW  
OF THE  
CHICAGO MERCANTILE EXCHANGE**

**Division of Trading and Markets  
June 26, 2002**

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# **RULE ENFORCEMENT REVIEW OF THE CHICAGO MERCANTILE EXCHANGE**

## **I. INTRODUCTION: PURPOSE AND SCOPE**

The Division of Trading and Markets (“Division”) has completed a rule enforcement review of the audit trail, trade practice surveillance, and disciplinary programs of the Chicago Mercantile Exchange (“CME” or “Exchange”) for compliance with applicable provisions of Section 5(d) of the Commodity Exchange Act (“Act”), as amended by the Commodity Futures Modernization Act of 2000 (“CFMA”). The review covers the period January 1 to July 1, 2001 (“target period”).<sup>1</sup>

The CFMA, which became effective on December 21, 2000, replaced prescriptive rules with broad, flexible core principles that are applicable to “designated contract markets.”<sup>2</sup> On August 10, 2001, the Commission published final rules implementing the CFMA with respect to trading facilities, including designated contract markets.<sup>3</sup> The final rules became effective October 9, 2001. Appendix B to Part 38 of the rules, which addresses designated contract markets, provides guidance and acceptable practices concerning the core principles with which a designated contract market must comply to maintain its designation. Although the guidance

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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 for the period under review. Such reviews deal only with programs directly addressed in the review and do not assess all programs. The Division’s analyses, conclusions, and recommendations are based, in large part, upon the Division’s evaluation of a sample of investigation and disciplinary case files, and other exchange documents. 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.

<sup>2</sup> Section 5(c) of the Act provides that a board of trade such as the CME that was designated as a contract market on the date of the enactment of the CFMA is deemed to be a “designated contract market” under the Act.

<sup>3</sup> See 66 F.R. 42255.

establishes non-exclusive safe harbors, it does not establish a mandatory means of compliance with the core principles.

The Division's review focuses on three core principles that relate to the Exchange's audit trail, trade practice surveillance, and disciplinary programs. Core Principle (2) - Compliance with Rules, and Core Principle (12) - Protection of Market Participants, relate to surveillance, enforcement, and disciplinary procedures used by a contract market to protect market participants from abusive trading practices. Core Principle (10) – Trade Information, relates to the maintenance of an audit trail that can be used to assist a contract market in the identification and prosecution of customer and market abuses. Appendix B to Part 38 provides acceptable practices for demonstrating compliance with Core Principles 2 and 10. Acceptable practices are not set forth for Core Principle 12, and therefore, no safe harbor has been established to date for that core principle.<sup>4</sup>

To assess compliance with these core principles, Division staff reviewed numerous documents used by the Exchange's Division of Market Regulation ("Market Regulation") in carrying out its routine oversight responsibilities. The Division also interviewed senior compliance officials and staff from Market Regulation with respect to the operation of the Exchange's compliance and surveillance programs.<sup>5</sup> The documents reviewed included, among others, the following:

- computer reports generated by CME's automated surveillance systems;
- trade practice investigation and disciplinary case logs;
- trade practice investigation and disciplinary action files;
- back office audit files containing trading card and order ticket recordkeeping reviews;

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<sup>4</sup> In promulgating Part 38, the Commission reserved the authority to adopt acceptable practices for compliance with Core Principle 12 at a later date.

<sup>5</sup> A copy of the transcript of those interviews can be found in Appendix 1.

- electronic reviews of all trades that focus on members' compliance with trade recordation requirements;
- compliance manuals and guidelines; and
- minutes of Board of Directors and disciplinary committee meetings held during the target period.

The Division provided the Exchange an opportunity to review and comment on a draft of this report on June 3, 2002. On June 11, 2002, Division staff conducted an exit conference with CME officials to discuss the report's findings and recommendations.

## II. SUMMARY OF FINDINGS AND RECOMMENDATIONS

### A. Audit Trail Program

#### Findings

- The Exchange maintains an adequate audit trail program that provides for the recording and safe storage of trade information in a manner that allows staff to use the information to assist in the prevention of customer and market abuses and to provide evidence of rule violations.
- The Exchange's automated trade timing system, using various timing data and other trade information, imputes the time of execution for each trade side.
- The Exchange's audit trail enforcement program includes daily computerized reviews of floor members' compliance with trade recordation requirements, called the "CTR Monthly Enforcement Program," and annual back office audits of clearing firms' data entry accuracy and recordkeeping compliance. Non-compliant firms and floor members who exceed allowable threshold levels are subject to summary fines.
- Back office audits were thorough, well documented, and completed in a timely manner. With the exception of the timely collection of endorsement cards that contain trades executed for other members on the floor, the back office audits indicated high levels of compliance with CME recordkeeping requirements.
- Indications of inaccurate data entry by clearing firms that are discovered in the course of floor members' appeals of summary fines for recordkeeping violations are not brought to the attention of the respective clearing firm so that it may take corrective action.

#### Recommendations

- **The CME should take steps to ensure that endorsement cards used for recording trades for other members present on the floor are collected and timestamped in a timely manner.**
- **The CME should institute a procedure whereby clearing firms are notified in writing of the types and extent of data entry errors detected during the course of administering the summary fine schedule for the CTR Monthly Enforcement Program. Where appropriate, firms should be requested to respond in writing with implemented or proposed corrective actions.**

## **B. Trade Practice Surveillance Program**

### **Findings**

- The Exchange maintains an adequate trade practice surveillance program through the use of an automated surveillance system, video surveillance, and floor surveillance.
- Investigations opened during the target period were initiated from various sources, including the Exchange's automated surveillance system, anonymous referrals, customer complaints, and floor surveillance. The majority of investigations were generated internally from automated surveillance.
- Investigations referred for disciplinary action involved analysis of substantial amounts of data and also frequently involved detailed analysis of videotape evidence. However, the Division was unable to fully evaluate the adequacy of several investigations that were not referred for disciplinary action because File Closing Forms used to document these investigations did not include sufficient information regarding the types of violations considered or the investigative analysis performed.
- Memoranda identifying interview tapes that are stored separate and apart from the investigation file, in several instances, were not maintained in the respective file. In addition, two investigation files that were closed with a recommendation for further monitoring of the subjects did not contain evidence that such monitoring occurred. Both of these issues were previously raised in the Division's 1999 Review of the CME.

### **Recommendations**

- **The Exchange should ensure that File Closing Forms contain sufficient information for any reviewer to determine that appropriate analyses were performed.**
- **The Exchange should ensure that memoranda are prepared itemizing the interview tapes associated with a particular file, and that follow-up monitoring of members is documented.**

## C. Disciplinary Program

### Findings

- The Exchange maintains an adequate disciplinary program. During the six-month target period, the Exchange imposed fines totaling \$720,750 against 151 individual members, member firms, and clerks. This amount includes fines for various trade practice, recordkeeping, and conduct violations.
- Trade practice violations resulted in sanctions against 11 members, one clerk, and one Globex terminal operator, and included \$521,500 in fines, suspensions totaling almost 11 years, and one permanent prohibition from applying for membership and from seeking employment on the trading floor. In addition, two members and one clerk were ordered to pay restitution totaling \$33,210. Penalties imposed appeared reasonable relative to the conduct being sanctioned, and cases promptly moved through the disciplinary process.
- In two instances, the Probable Cause Committee determined not to accept Exchange staff's recommendation to issue charges for a specific violation or reduced the recommended charges from major to minor offenses, without explanation in the relevant case file or committee minutes.

### Recommendation

- **The Probable Cause Committee should document its reasoning for not issuing a particular charge or reducing charges that are recommended by Market Regulation staff.**



### III. AUDIT TRAIL PROGRAM

#### Core Principle (10) – Trade Information:

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

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

Original source documents include unalterable, sequentially identified records on which trade execution information is originally recorded, whether recorded manually or electronically. A transaction history consists of an electronic history of each transaction, including all data that are input into the trade entry or matching system for the transaction to match and clear. These data should include the categories of participants for whom such trades are executed; timing and sequencing data adequate to reconstruct trading; and the identification of each account to which fills are allocated. An electronic analysis capability permits sorting and presenting data included in the transaction history so as to reconstruct trading and to identify possible trading violations, while safe storage capability provides for a method of storing the data included in the transaction

history in a manner that protects the data from unauthorized alteration, accidental erasure or other loss.

#### **A. Order Flow and Recordkeeping Requirements**

Orders are typically transmitted to CME's trading pits by "flashing," electronic order routing systems or hard copy floor order tickets. Flashed orders are hand signaled from the initiating firm's floor order desk, where the order is written up, or from other members present on the floor.<sup>6</sup> Electronically transmitted orders to the floor are sent from remote locations outside of the Exchange to firms' floor order desks or directly to terminals in the pit. These orders may be sent through a member firm's proprietary order routing system or through the CME's order routing system, the Trade Order Processing System ("TOPS"). The orders can then be routed to CME Universal Broker Station ("CUBS") terminals, which are located in the trading pits. CUBS terminals receive and organize orders and transmit filled trade information back to the originating source and to the Exchange's clearing house.

Upon execution, floor brokers record fill information for customer orders on floor order tickets, whether electronically-generated or handwritten. Trades for a member's personal account are recorded on sequenced trading cards, while trades for other members on the floor and flashed orders are recorded on endorsement cards.<sup>7</sup> Pursuant to CME Rule 536, the data recorded on order tickets and trading cards at the time of execution must include the executing

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<sup>6</sup> Most orders for currencies and financial contracts are flashed into the pit, while the vast majority of orders for agricultural commodities are hand carried into the pit.

<sup>7</sup> An endorsement card is usually a non-sequenced trading card that is used to record the trade data for a floor order that has been flashed either from the clearing firm's order desk or from another floor member, i.e., customer type indicator ("CTI") 3 trade. After the trade has been executed, the floor member or his/her clerk fills out the endorsement card and returns it to the firm's order desk where it is attached to the hard copy of the flashed order. If flashed by another floor member, the CTI 3 endorsement card must be submitted with the personal trading card used by the originating floor member to record the order. The executing member must record the time of execution on the CTI 3 endorsement card. These cards are then attached to each other at the initiating floor member's clearing member firm and timestamped. These trade data are submitted by the clearing member firm electronically to the clearing house for matching and clearing.

member's name or symbol, the name of the member firm clearing the trade, the date, price, quantity, commodity, contract month, time bracket symbol,<sup>8</sup> opposite member and clearing firm and, for options, the strike price, "put" or "call" indicator, and expiration month. Order tickets are timestamped when received on the floor ("entry time") and at the time the fill is reported to the customer ("exit time"). In addition, order tickets must contain an account identifier and an order number.

Trading cards used for personal trades are single-sided and must contain a pre-printed sequence number and the floor member's trading symbol. In addition, all transactions must be recorded in the order in which they were executed in non-erasable ink, and no more than six trades may be recorded on a single card. A floor member may correct errors by crossing off erroneous information but without obliterating the recorded information. Further, the floor member may not skip any lines when recording trades and must cross out any unused lines before starting a new card. Finally, a new trading card must be used at the start of each 15-minute time bracket. All floor order tickets, personal trading cards and endorsement cards are required to be collected by clearing member firms and timestamped within 15 minutes of every half-hour time period in which the trade was executed.<sup>9</sup>

Orders executed on the CME's electronic trading system, Globex, are either entered by a customer through the use of a clearing member or third party order routing system via the CME's Application Program Interface, or by calling the order to the clearing member firm's office and having it entered by a Globex terminal operator. The terminal operator must be either an

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<sup>8</sup> Time brackets are designated by symbols that represent each 15-minute time period during the trading day, starting at 7:00–7:15 a.m., which is designated as time bracket "A". Separate time bracket symbols are assigned for the opening range, closing range, and post-close session.

<sup>9</sup> Floor orders are only required to be collected when they have been completely filled, when the floor member determines that he or she is unable to fill any remaining quantities, or when the unexecuted remaining quantities are cancelled.

Exchange floor member or authorized to enter orders by the clearing member firm. Before entering Globex orders, the operator must log on to the terminal and input a unique user identification assigned by the Globex Control Center.

Similar to floor orders, Globex orders must contain the price, quantity, commodity, contract month, CTI code, account identification, and for option orders, the strike price, “put” or “call,” and expiration month. If a Globex terminal operator receives an order that cannot immediately be entered into Globex, the operator must prepare a written order and include the account identification, date, time of receipt and other required information. The order then must be entered into Globex by the operator when it becomes executable. Globex orders are then matched pursuant to its trade matching algorithm, and the trade record is electronically sent to the customer’s clearing member firm. Globex also automatically records the time of order entry, trade matching, and any changes made to an order.

#### **B. Execution Time for Pit Trades**

The Exchange’s Regulatory Trade Timing (“RTT”) system uses the timing indicia recorded on order tickets and trading cards, along with time and sales information, to impute a time of execution for each trade side. These data include entry and exit timestamps from customer order tickets, execution times recorded on CTI 3 endorsement cards for trades executed for other members on the floor, the beginning and ending times of 15-minute brackets, trading card sequence numbers, the sequence of trades on trading cards, and other required handwritten execution times, such as for crosstrades. From these data, a series of timing windows are formed using each “start” and “end” time.<sup>10</sup> The timing windows are then compared to the time and

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<sup>10</sup> Some examples of timing window start times would be the entry timestamp from a floor order or the beginning of the time bracket. End times would include the CTI 3 broker execution time, exit timestamp, or end of the time bracket.

sales and the time of the price quote that is found within the most timing windows is considered to be when the trade is most likely to have occurred.

RTT execution times and trade data collected from floor trading documents are used by Market Regulation to reconstruct trading activity. Trade timing data also are incorporated into reports stored in the Exchange's Virtual Detection System ("VDS") and Regulatory Trade Browser ("RTB"). VDS houses various reports that list information and isolate transactions for further follow up, and RTB allows staff to generate customized reports for surveillance and investigatory purposes.<sup>11</sup> The effectiveness of the Exchange's surveillance applications and RTT are dependent upon the proper recordation of trade data by floor members, and the subsequent accurate entry of such data by clearing members, because missing or incorrect timing data may lead to incorrect trade times. The Exchange routinely conducts audit trail reviews to ensure the accuracy of trade data.

### **C. Audit Trail Reviews**

Audit trail reviews consist of two separate programs. First, the Exchange conducts back office audits of member firms.<sup>12</sup> Back office audits focus on clearing member firms' entry of trading data into the clearing house system for use in imputing RTT times. Market Regulation analysts examine a sample of floor orders, personal trading cards and endorsement cards for accounts cleared by the member firm being audited, and compare the information on the documents to the firm's cleared trades report. Second, CME conducts a daily electronic review of all trades, which focuses on floor members' compliance with certain trade recordation requirements. This program is referred to as the "CTR (Computerized Trade Reconstruction)

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<sup>11</sup> See Section IV.C. at pp. 26-29 for a discussion of VDS and RTB and how they are used by Market Regulation to conduct investigations.

<sup>12</sup> Back office audits are conducted a minimum of once a year at each member firm. Additional audits may be conducted if Market Regulation identifies or suspects audit trail irregularities.

Monthly Enforcement Program.” Each program includes a separate summary fine schedule that is administered by Market Regulation.

### **1. Back Office Audits**

Market Regulation employs three data analysts, a senior analyst and a Manager to conduct back office audits. Before initiating a back office audit, an analyst issues a letter to the member firm informing it of the upcoming audit and that all trading documents for the target date, *i.e.*, the trade date prior to the date of the letter, must be made available for review. The analyst also provides the firm with a questionnaire that requests background information with respect to the firm’s procedures for monitoring, among other things, keypunch errors, timestamping errors, floor document pick-up times, CTI coding, and flashed order requirements. The analyst also reviews the prior back office audit of the firm to note any deficiencies found, and reviews any disciplinary actions issued to the firm for possible audit trail violations. In addition, the analyst requests the following CME reports in preparation for the audit: CTR Process Type “E” Timestamp Report,<sup>13</sup> Timestamp In/Timestamp “T” Report,<sup>14</sup> Card Sequence “C” Report,<sup>15</sup> Execution Timestamp Report,<sup>16</sup> and CTR Error Report.<sup>17</sup> These reports alert the analyst to possible problems the firm may have with timestamping requirements, manually-recorded execution times, and trade sequencing on personal trading cards.

During an on-site visit, the analyst randomly selects a minimum of 50 personal trading cards, 50 floor order tickets, and 50 CTI 3 endorsement cards for review.<sup>18</sup> If a member firm

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<sup>13</sup> The CTR Process Type “E” Timestamp Report lists all trades that should contain a handwritten execution time.

<sup>14</sup> The Timestamp In/Timestamp “T” Report lists all trades which should contain timestamps.

<sup>15</sup> The Card Sequence “C” Report lists all trades executed by floor members for their own accounts.

<sup>16</sup> The Execution Timestamp Report lists all trades with manual times of execution (CTI 3 trades).

<sup>17</sup> The CTR Error Report lists all trades for which required trade data were missing when submitted.

<sup>18</sup> Large member firms may warrant a larger sample size. This is determined by the Market Regulation Manager. The selection of the CTI 3 endorsement cards is to focus on the recording of the handwritten execution times.

lacks the minimum number of documents in any category, all of the trading documents in that category are reviewed during the audit. In addition, if the firm's questionnaire indicates that it has written Globex orders, the analyst includes a sample of those orders in the audit. The documents are examined for compliance with Exchange requirements such as collection and entry and exit timestamps, account identification, the use of non-erasable ink, and the crossing out of unused lines on personal trading cards. The analyst uses a checklist to ensure that all pertinent information is reviewed.

Upon completion of an audit, the analyst notifies the member firm by letter of any violations found and the amount of any summary fines associated with those violations. A summary fine is issued to the firm if the audit reveals violations exceeding allowable threshold levels.<sup>19</sup> The Exchange uses the following levels of noncompliance when applying summary fines: (1) failure to collect documents in accordance with CME's schedule- 15 percent for sequenced trading cards and CTI 3 endorsement cards and 10 percent for floor orders; (2) failure to accurately submit and record order type indicator-10 percent; and (3) failure to accurately submit flashed order indicator-10 percent. A first offense results in a \$1,000 fine, a second offense results in a \$2,500 fine, and a third offense results in a \$5,000 fine. Any subsequent offense within 24 months results in a \$10,000 fine.

During the target period, Market Regulation conducted 39 back office audits. A total of 2,140 floor orders, 1,348 personal trading cards, and 882 CTI 3 endorsement cards were examined. The trading documents were prepared by a total of 1,413 floor members. With the exception of the timely collection of CTI 3 endorsement cards, the audits indicated high rates of compliance with CME audit trail recordkeeping requirements. Specifically, all of the floor

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<sup>19</sup> Floor members whose trading documents were reviewed during the audit also receive a reminder letter if a deficiency was found in the recording of trade information. Floor members are also subject to summary fines under the CTR Monthly Enforcement Program, discussed below.

orders examined contained account identification; 2,103 (98 percent) included both entry and exit timestamps; 2,049 (95 percent) of the entry and exit timestamps were accurately entered into the clearing house system; and 1,965 (92 percent) were collected and timestamped in accordance with the Exchange's collection schedule. In addition, 2,007 (94 percent) of the floor orders were flashed orders and were correctly identified as such; 2,030 (95 percent) of the floor orders indicated accurate order type indicators; and 2,021 (94 percent) of the floor orders were timestamped using trading floor clocks that were in synchronization with the Exchange's master clock.<sup>20</sup>

With respect to personal trading cards and CTI 3 endorsement cards, the audits indicated that 1,236 (92 percent) of the personal trading cards were collected and timestamped within required time periods. In addition, 857 (97 percent) of the CTI 3 endorsement cards indicated that the broker recorded an execution time, and all of those times were accurately entered into the clearing house system. Further, 1,292 (96 percent) of the personal trading cards, and 839 (95 percent) of the CTI 3 endorsement cards contained collection timestamps that were synchronized with the Exchange's master clock. However, only 684 (78 percent) of the CTI 3 endorsement cards were collected and timestamped in accordance with the CME's collection schedule. The Exchange needs to improve compliance in this area.

The Division's review of the Exchange's back office audits indicates that the audits were thorough, well documented and completed in a timely manner. The audit files contained copies of original floor orders, personal trading cards and CTI 3 endorsement cards examined during the audit, worksheets and spreadsheets prepared by the analyst and, if a fine was levied, a copy of the member firm's payment. Each file also included an initiating form that indicated the date the

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<sup>20</sup> Market Regulation also tests the accuracy of all timestamp machines on the trading floor on a monthly basis. The firm's timestamp is compared to the main clock located on the floor of the CME. During the course of a back office audit, Market Regulation looks for obvious timestamp irregularities.



audit was assigned, the review date, target date and closing date, correspondence with the member firm, a copy of the prior back office audit, and any prior relevant disciplinary actions. The 39 back office audits, from initiating letter until acknowledgement of deficiencies by the member firm, took an average of 28 days to complete. As a result of the audits, 15 firms were fined a total of \$18,000 pursuant to the Exchange's summary fine schedule, and 11 floor members received deficiency letters. Of the \$18,000, six firms were fined \$1,000 each for untimely collection of CTI 3 endorsement cards.

## **2. CTR Monthly Enforcement Program**

Effective January 2001, the Exchange instituted a summary fine schedule for recordkeeping violations identified by the CTR Monthly Enforcement Program. This program, which supplements the back office reviews, consists of a computerized review of each trade on a daily basis for possible floor member recordkeeping exceptions. At the end of each month, the exceptions are totaled and members exceeding threshold levels are issued warning letters or summary fines. Both the warning letters and summary fines are issued by Market Regulation. Market Regulation may rescind warning letters and fines if a floor member is able to produce evidence to indicate that he or she recorded the trade data accurately, but that the data were incorrectly entered by the clearing firm.

The program reviews trades for: (1) bracket exceptions, where a floor member does not indicate a time bracket or reports an erroneous time bracket; (2) time of execution exceptions, which indicate that a required execution time for a CTI 3 order was not recorded or submitted; (3) sequence errors, which indicate that the imputed time for a trade was recorded or input into the clearing system out of chronological order with other trades recorded on the trading card; and

(4) quotes not found in the time and sales, where the price of a trade is not found on the time and sales. In addition, member firms are subject to summary fines for timestamp exceptions.<sup>21</sup>

The threshold levels for floor member noncompliance are set at six percent or above for bracket exceptions; eight percent for time of execution exceptions; five or more quotes not found in time and sales for futures trades, and 10 or more quotes for option trades; and eight percent for sequence errors. The threshold level for timestamp exceptions for member firms is set at seven percent. Floor members found exceeding threshold levels are issued a warning for the first offense; a \$500 fine for the second offense; a \$1,000 fine for the third offense; and a \$5,000 fine for any additional offenses within a 12-month period. Member firms found to have violated the timestamp exception threshold receive a warning for the first offense; a \$1,500 fine for the second offense; a \$5,000 fine for the third offense; and a \$10,000 fine for any additional offenses within a 12-month period. In addition, Market Regulation may refer matters that it deems egregious to the Probable Cause Committee for consideration of further disciplinary action.

Under the CTR Monthly Enforcement Program, Market Regulation issued 679 warning letters and 209 fines totaling \$140,500 to floor members during the target period. Of these, 287 warnings (42 percent) and 113 fines (54 percent), totaling \$72,500, were rescinded upon a showing by members that erroneous clearing firm entries caused the exceptions. In addition, 15 warning letters and nine fines totaling \$29,000 were issued to member firms for timestamp exceptions, with one warning and two fines totaling \$15,000 being rescinded. These were rescinded upon a showing of technical problems or other mitigating circumstances which were already corrected.

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<sup>21</sup> A timestamp exception occurs when an entry or exit timestamp is missing, if the entry timestamp was later than the exit timestamp, if the clearing house receipt time is before the exit timestamp or if the time submitted was not between 0001 and 2400 hours.

These statistics show that a high percentage of warnings and fines issued to floor members through the CTR Monthly Enforcement Program are rescinded, indicating that trade data in many instances are not being entered correctly by clearing firms into the clearing house system. However, Market Regulation has no policy or procedure for informing clearing firms of the data entry errors causing the exceptions. The Division believes that the CME should institute a procedure whereby clearing firms are notified in writing of the types and extent of data entry errors identified during the course of administering the summary fine schedule. In addition, where appropriate, Market Regulation should request that the firm set forth in writing the remedial steps it has taken, or plans to take, to address the problem areas. This would further enhance the reliability of the data entry process and the Exchange's audit trail generally.

**D. Safe Storage Capability**

CME trade data and the transaction history are stored and maintained in the Exchange's mainframe system. The mainframe system is protected from unauthorized alteration and accidental erasure by the RACF Security System. The RACF Security System is used industry-wide for the protection and prevention of unauthorized entry. In addition, data are backed up and stored on other CME computers, as well as at a private storage facility off the Exchange's premises. The Exchange is currently developing a mainframe system outside of the Chicago area that would contain all trade data and transaction history. This system would allow the Exchange to trade its products electronically on Globex in the event that its markets were unable to operate from their current environment.<sup>22</sup> Although the Exchange is required to retain its records for a minimum of five years under Commission regulation 1.31, it historically has retained trade information for a longer period of time.

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<sup>22</sup> This facility is expected to be launched in 2002.

## **E. Conclusions and Recommendations**

The Division found that the Exchange maintains an adequate audit trail program. The Exchange maintains rules and procedures that provide for the recording and safe storage of identifying trade information in a manner that enables CME's Market Regulation staff to use the information to assist in the prevention of customer and market abuses and to provide evidence of any rule violations. The Exchange's program for enforcing its audit trail rules allows staff to reconstruct the path of a customer order from time of receipt to fill allocation or other disposition. The enforcement program consists of annual back office audits of clearing member firms that review compliance with recordkeeping requirements and the accuracy of data entry, and a daily automated review of floor member compliance with trade recordation requirements. Both components of the program include separate summary fine schedules that are administered by Market Regulation.

The Exchange's back office audits were thorough, well documented and completed in a timely manner, taking an average of 28 days to complete. With one exception, the Division's review indicated high rates of compliance with CME audit trail recordkeeping requirements. The Division found that only 78 percent of the CTI 3 endorsement cards were collected in accordance with the Exchange's trading card collection schedule during the target period. The Division also found that indications of inaccurate data entry by clearing firms that are discovered in the course of floor members' appeals of summary fines for recordkeeping violations are not

brought to the attention of the respective clearing firm so that it may take appropriate corrective action.

Based on the foregoing, the Division recommends that the Exchange:

- **Take steps to ensure that endorsement cards used for recording trades for other members present on the floor are collected and timestamped in accordance with Exchange rules.**
- **Institute a procedure whereby clearing firms are notified in writing of the types and extent of data entry errors detected during the course of administering the summary fine schedule for the CTR Monthly Enforcement Program. Where appropriate, firms should be requested to respond in writing with implemented or proposed corrective actions.**

#### **IV. TRADE PRACTICE SURVEILLANCE PROGRAM**

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

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

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

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

Pursuant to Appendix B to Part 38 of the Commission's regulations, a contract market's trade practice surveillance program should have the arrangements, resources, and authority necessary to perform effective rule enforcement. The arrangements and resources attendant to the program should facilitate the direct supervision of the contract market, including analysis of relevant data. The program also should have the authority to discipline, suspend, or terminate the activities of members or market participants pursuant to clear and fair standards.

An acceptable trade practice surveillance program should maintain all data reflecting the details of each transaction executed on the contract market. In this regard, the program should include routine electronic analysis of these data to detect potential trading violations.

Additionally, the program should provide for appropriate and thorough investigation of all potential trading violations brought to the contract market's attention. Further, an acceptable trade practice surveillance program should provide for prompt and effective disciplinary action for any violation that is found to have been committed.

## **A. Staffing and Division of Duties**

### **1. Market Regulation Staffing**

Market Regulation, which is part of the Exchange's Business Administration Division, administers the Exchange's trade practice surveillance and market surveillance programs.

Market Regulation includes 43 individuals who are responsible for detecting, investigating, and prosecuting trade practice violations. Market Regulation's trade practice surveillance

management team, which includes the Director of Market Regulation, four Associate Directors, and four Managers, reports to the Managing Director of Regulatory Affairs.<sup>23</sup> The remaining

trade practice surveillance staff is divided into compliance systems staff, regulatory program investigators, data analysts, daily investigators, general investigators, trading floor investigators,

and administrative support staff. Exchange investigators are further classified as "senior investigator," "experienced investigator," or "investigator," depending upon the assigned level of responsibilities.

### **2. Division of Duties**

Market Regulation's compliance systems staff provides data processing support for CME's investigative activities. Regulatory program investigators are responsible for monitoring compliance with specific Exchange rules regarding dual trading, trading within broker associations, top step trading restrictions, and out-trade assignments. Data analysts conduct audit

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<sup>23</sup> The Managing Director of Regulatory Affairs has served in this position for the past year. Prior to this appointment, his Exchange experience, which totals 24 years, included eight years as Senior Vice President Regulatory Affairs, two years as Vice President of Market Regulation, three years as Vice President of Market Surveillance, and six years as a Market Regulation Director. The Director of Market Regulation has 21 years of Exchange compliance experience and the four Associate Directors have combined Exchange compliance experience totaling 60 years (one Associate Director with 24 years of experience, one Associate Director with 14 years of experience, and two Associate Directors with 11 years of experience). The four trade practice surveillance Managers have combined Exchange compliance experience totaling 42 years (one Manager with 18 years of experience, one Manager with 13 years of experience, one Manager with seven years of experience, and one Manager with four years of experience).

trail reviews of trading records and clearing submissions to determine whether required information is being properly recorded and accurately reported to the Exchange.

The Exchange's daily investigators analyze exception reports and conduct analysis of cleared trades and other data to detect potential trading violations with respect to both open outcry trading and Globex trading. If a daily investigator identifies trading activity that he or she believes may violate an Exchange rule, the matter is referred to a general investigator for further investigation. Although general investigators are responsible for conducting full-scope investigations, including gathering and analyzing trading documents and interviewing relevant individuals, daily investigators often remain involved in larger investigations until the investigation is concluded. If an investigation is concluded and a determination is made to refer the matter to a disciplinary committee, the general investigator is responsible for preparing an Investigation Report and presenting evidence at any resulting disciplinary proceeding.

The Exchange also employs four former members as trading floor investigators. The trading floor investigators conduct visual floor surveillance throughout the trading day on the Exchange's two trading floors and communicate frequently with daily and general investigators regarding their observations. Although all markets are observed during the trading day, primary emphasis has been placed in the "equities quadrant" over the past two years due to high volume, volatility, and anonymous complaints.<sup>24</sup> Observations made by trading floor investigators often result in more targeted analysis of individuals by daily investigators and may result in follow-up video surveillance, as described below. Additionally, individuals on the trading floor who want to report questionable trading activity, but wish to remain anonymous, frequently convey their suspicions to Market Regulation through the trading floor investigators.

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<sup>24</sup> The equities quadrant includes all S&P products, the NASDAQ-100 Stock Index ("NASDAQ-100"), Russell 2000 Stock Price Index, and Nikkei futures and options. At least one trading floor investigator observes trading in the NASDAQ-100 pit throughout the trading session.



The Exchange's trading floor investigators, along with other Exchange operational staff, also serve as the pit committee for the Australian Dollar market. In addition, trading floor investigators and Exchange operational staff serve as Vice Chairmen of the NASDAQ-100 pit committee.<sup>25</sup> Finally, pursuant to CME Rule 415.A., trading floor investigators also have the authority to charge individuals for trading infractions listed in CME Rule 514. These infractions include, among other things, a bid or offer out of line with the market, price infractions, failure to confirm a transaction, and unbusinesslike conduct.

Four investigations were opened during the target period that substantially relied upon the input and expertise of trading floor investigators. The investigations examined the trading activity of seven individual members. One member was fined \$2,500 for trading ahead in the Australian Dollar pit,<sup>26</sup> two members in the NASDAQ-100 pit remain under investigation for possible noncompetitive trading,<sup>27</sup> and investigations involving four members were closed in the S&P and Eurodollar pits.<sup>28</sup> The latter investigations involved possible disclosure of orders and violations of dual trading restrictions.

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<sup>25</sup> Typically, pit committees are comprised of members who trade in a particular pit. However, because the Australian Dollar pit is lightly populated (there are approximately eight members in the pit), which makes it difficult to constitute a pit committee, and there have been disputes between members that affected the orderliness of the market, the Exchange, in April 2000, gave pit committee responsibility to Exchange trading floor investigators. In August 2000, the Exchange added trading floor operations staff to the Australian Dollar pit committee. At about the same time, the Exchange took the additional step of reconfiguring the NASDAQ-100 pit committee by appointing the trading floor investigators and six trading floor operations Managers to serve as Vice Chairmen of that pit committee. The increased regulatory presence on the committee was taken in response to increased volatility in the NASDAQ-100 and several complaints alleging improper trading.

<sup>26</sup> Case No. 01-18771. As explained in Section IV.D. at p. 30, the Exchange has instituted a new case tracking system in which each investigation is assigned a case number, along with an accompanying file number for each member involved in that case. For purposes of this report, individual file numbers only will be cited in addition to case numbers if relevant.

<sup>27</sup> Case No. 01-18883; File Nos. 18883 and 18884.

<sup>28</sup> Case Nos. 01-18393 and 01-18552.

## **B. Video Camera Surveillance**

CME's video surveillance program, which is unique among domestic exchanges, is an important tool for resolving outrades and is an important component of the Exchange's trade practice surveillance program. Three separate systems comprise the CME's video camera surveillance.<sup>29</sup>

The "Video Trade Resolution System" ("VTRS") is a digital video recording system that encompasses 34 cameras with various angles throughout CME's entire equities quadrant, including most of the active booth spaces. VTRS data are digitally stored and generally are maintained through trade date ("T") + 1. The Exchange's second video camera surveillance system is the "Video Logging System." The Video Logging System, which is older than VTRS, encompasses 44 analogue cameras throughout the "interest rate quadrant."<sup>30</sup> Video Logging System data are stored on videotape and are kept through T+ 3.<sup>31</sup> Both of these video systems run throughout the trading day and primarily are used by members and member firms for resolving outrades. Market Regulation staff also can utilize VTRS and Video Logging System data for investigative purposes, provided that a request is made to save the data before the data are erased or recorded over.

The Exchange's third video surveillance system, "Video Surveillance," is specifically used by Market Regulation in connection with substantive investigations that typically involve a pattern of conduct. This system, which encompasses 19 cameras (ten on the upper trading floor and nine on the lower trading floor) positioned at various locations around the trading floors, has

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<sup>29</sup> The Exchange's video surveillance systems do not possess audio capabilities.

<sup>30</sup> The interest rate quadrant includes Agency Notes, Eurodollars, EuroYen, Japanese Government Bonds, LIBOR, Quarterly Bankruptcy Index, Swap Futures, Treasury Bills, and Turn Rates.

<sup>31</sup> The technology associated with VTRS accounts for the storage difference between VTRS (T+1) and Video Logging (T+3).

superior zooming capabilities. For example, a camera can be positioned to look over a person's shoulder at a trading desk to view trading documents. The Video Surveillance system is primarily operated by the daily investigators, who also typically perform the initial review and analysis of the resulting video. Images are digitally recorded on high-quality videotape. In order to use Video Surveillance, staff must first obtain permission from the Managing Director of Regulatory Affairs or the Director of Market Regulation.

The Exchange's Video Surveillance system played a significant role in several investigations opened during the target period. Videotape often can provide clear evidence of wrongdoing that may otherwise be difficult to identify and prove. For example, Market Regulation initiated two investigations involving misuse of the Exchange's error account rule and noncompetitive trading that resulted in disciplinary action.<sup>32</sup> In the first investigation, Market Regulation's review of videotape of the S&P 500 pit suggested that an S&P top step order filler and a local traded noncompetitively with another broker through the assistance of the broker's clerk.<sup>33</sup> Videotape showed the broker receiving orders and relaying purported fills of the orders without competitively executing any trade. By various methods, trades were put into the broker's error account. The broker then offset each trade opposite either the top step order filler or the local for a profit. Each time the customer was cheated. In one instance, the top step order filler was not even in the pit, but the broker recorded a trade with the top step order filler on his trading card. The broker's clerk assisted the broker by withholding orders and matching them or writing-up trades that did not occur.

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<sup>32</sup> The sanctions imposed in both cases are discussed in Section V.C. at pp. 42-43.

<sup>33</sup> Case No. 00-17530. CME Rule 541 prohibits floor brokers from dual trading on the top step of the S&P pit. Only customer orders can be filled from the top step. A copy of the Investigation Report can be found in Appendix 2.

The Exchange's Video Surveillance system also played a large role in an investigation initially opened based on Market Regulation's routine analysis of trade data in the S&P 500 pit.<sup>34</sup> As part of the investigation, Market Regulation videotaped a broker's trading activity for a two-week period. The videotape showed the broker engaging in noncompetitive, prearranged trading with two other brokers (the "accommodating brokers") during the opening on various trade dates. Further, one of the accommodating brokers assigned the opposite side of customer orders to his error account without offering the trades to the market.

### **C. Automated Computer Surveillance**

#### **1. Virtual Detection System**

The Exchange replaced its automated surveillance system, the Automated Trade System ("ATS"), during the last quarter of 1999. The Exchange's new automated surveillance system, the Virtual Detection System, stores reports for pit trades based on cleared trade and quotation data. VDS has increased functionality and a more contemporary, user-friendly display than ATS. Users perform tasks simply by clicking a mouse button or manipulating objects on a screen. VDS also provides users with the ability to view trade data across dates and to select data in a more customized manner. For example, users can select data within all reports by broker, trade date(s), commodity, contract month, individual firm or account number, and by dollar value in the Profit and Loss Report. VDS also has an ad hoc selection feature that permits users to retrieve data for a particular trade either by an individual broker or order number. Additionally, for some reports, VDS has an interface that allows users to adjust parameters. This interface is easier to use than the system that was previously used to adjust ATS parameters.

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<sup>34</sup> Case No. 00-17293. The Division also uncovered questionable trading activity regarding the same individual while conducting routine oversight and had referred the matter to the Exchange. A copy of the Investigation Report can be found in Appendix 3.

VDS reports, which are generally reviewed weekly by daily investigators, include the Market Analysis Report, which isolates unique price movements in time and sales listings to locate significant market movements that may be conducive to trading ahead of a customer's order; the Trading Ahead of Customer Orders Report, which compares the trading activity of the personal accounts of a filling broker to the customer orders that the broker filled during a market rally or a break identified by the Market Analysis Report; the Top Step Violation Report, which shows when a member registered as a top step broker in the S&P 500 pit trades for his or her personal account; and the Broker Direct Trading Opposite Customer Orders Report and Broker Indirect Trading Opposite Customer Orders Report, which identify brokers that trade opposite their customer orders directly or using accommodators.

Other VDS reports are the Direct or Single and Multiple Wash Trades Report; the Outtrade Analysis Report; the Indirect Trading with Collaborator Report, which highlights a combination of potential trading ahead and trading against violations where the filling broker attempts to avoid detection by using another member's account rather than his or her own account to take advantage of an order; the Daily and Month-End Profit and Loss Reports; and the Trade Percentages Report, which displays the monthly cumulative trading percentage by broker opposite other traders. The defaults and parameters set for each report differ by commodity. Although VDS report defaults and parameters can be modified for processing future data, data that have already been processed cannot be re-run using the modified default parameters.

## **2. Globex Exception Reports**

Globex reports are not available in VDS, but may be stored in VDS in the future. Currently, Globex reports are archived to a CD-ROM optical disc system. The Globex exception reports include several reports that are very similar to open outcry trading exception reports. These include the Globex User Direct Trades Opposite Customer Orders Report and the Globex

Indirect Trades Opposite Customer Orders Report, the Globex Single Account Wash Trades and Multiple Account Wash Trades Report, the Globex Indirect Trading Opposite Customer Orders With Collaborator Report, and the Globex Trade Percentages Report.<sup>35</sup>

In addition, Market Regulation uses reports that are unique to Globex. For example, CME requires that when market participants engage in pre-execution discussions, one side must be exposed to the market for five seconds in futures and 15 seconds in options before the other party to the discussion can take the opposite side of the order.<sup>36</sup> The Globex Monitoring for Pre-Execution Report reviews the trading of a firm against its customers' orders and displays instances in which 5 seconds or less elapsed between placement and execution. The Globex Trading Ahead of Customers Report is also unique. The report scans trading activity for trading ahead exceptions in the Globex market, the side-by-side open outcry market, and between both markets. The side-by-side markets that are compared for purposes of this report are futures and E-mini contracts in S&P 500, NASDAQ-100, Eurodollars, and Feeder Cattle.

### **3. Regulatory Trade Browser**

Regulatory Trade Browser is an ad hoc desktop tool that allows Market Regulation staff to select and sort data. For example, Market Regulation staff may use RTB to further analyze potential trading violations identified in VDS and Globex exception reports, or they may use RTB to create customized reports in furtherance of investigations. RTB data are drawn from the Exchange's cleared trade data and include every piece of open outcry and Globex cleared trade data that the Exchange has regarding a particular trade.<sup>37</sup>

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<sup>35</sup> The Globex Trade Percentages Report is similar to its open outcry counterpart except that this report aggregates and compares trade percentages by (1) user i.d. versus other user i.d. and (2) user name versus other users by name.

<sup>36</sup> See Special Executive Report 2-2631, March 8, 1993. Revised September 1993, SER S-2707; December 2000 SER S-3624.

<sup>37</sup> RTB contains all trade data from 2000, 2001, and year-to-date 2002. Older data are available through a request to the Exchange's Management Information Systems Division.

While VDS outputs are generally in the form of exception reports, RTB permits users to query any field of trade data or any combination of fields to create reports that can be displayed in multiple formats. Examples of RTB queries include requests by any criteria on the trade record, including, but not limited to, trades by account number; filling broker at a specific firm; filling broker for a given time period; clearing firm; trading card sequence number; personal account; order number; commodity; closing or opening range; bracket period; broker symbol; and any specified time period. As noted above, users also can query several fields to create a report. For example, a daily or general investigator could query RTB to identify all spread trades of a certain size (*e.g.*, greater than ten contracts) executed in a specified commodity during a particular bracket. The query could be further tailored to identify spread trades executed between certain members. The resulting report could be sorted and downloaded into an Excel spreadsheet. RTB reports are often included as evidence in Investigation Reports.

#### **4. Other Databases**

Other sources of data available to Market Regulation staff for conducting investigations are the Exchange's Interested Party and Accounts Database ("IP/Accounts Database") and the Large Trader Database. These data are available via desktop applications.

The IP/Accounts Database provides information concerning members, member-employees, member and related firms, Exchange committees, registered broker associations, and accounts that are owned and/or controlled by members. Data included in the IP/Accounts Database are generated from the Exchange Membership Database and include specific member account number information. The Large Trader Database, which is primarily used for market surveillance purposes, consists of current and archived information regarding open positions of all traders who carry positions larger than the reporting level. This information includes firm, name, address, and other details regarding accounts that have become reportable.

#### **D. Case Tracking System**

Since the 1999 Review, the Exchange has implemented a new case tracking system. The new system, a Microsoft Access database, includes information relating to the date a matter is opened, subject, complainant, incident dates, case type (topic), commodity, description of allegations, investigative phase, date referred for charges, date referred to disciplinary committee, hearing dates, applicable rule, verdict/findings, fine, fine waived, fine paid, suspension, suspension start and end dates, expulsion, restitution, date closed, effective date, warning letters, and findings.

Under the Exchange's new case tracking system, sequential case numbers are assigned to any Market Regulation investigation. In addition, each case number is assigned a separate file number for each individual or firm whose activity is being examined. For example, if Market Regulation begins to examine trading activity among three members, a case number is assigned to the matter along with three separate file numbers (the first file number assigned is the same as the case number). If the case is completed with respect to one individual, but ongoing with respect to the remaining two individuals, the file relating to the individual for whom the case is completed is appropriately marked and tracked by Market Regulation and the other two files remain open. This system allows the Exchange to maintain accurate, up-to-date data regarding any individual or firm that is engaged in potentially violative trading activity.

#### **E. Timeliness of Investigations**

The Division found that the Exchange's investigations were completed in a timely manner.<sup>38</sup> During the target period, the Exchange closed 224 trade practice files that were opened in conjunction with 187 investigations, including 92 files that were part of 43

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<sup>38</sup> The Division calculated the Exchange's timeliness statistics based on the number of files closed during the target period.



investigations opened prior to the start of the target period. The Division found that of the 224 files, 137 files (61 percent) were closed within four months; 23 files (10 percent) were closed within four to six months; and 46 files (21 percent) were closed within six months to one year. Eighteen files (eight percent) were open longer than one year.

The Division examined each of the 18 files, representing seven investigations that were open longer than one year. Although the age of these files ranged from 382 to 468 days, the Division found that they were justifiably open for the longer periods of time based on several factors. Specifically, the files involved complex fact patterns, required numerous interviews and document requests, and frequently required detailed review of videotape evidence. Further, 12 of the 18 files resulted in referral to a disciplinary committee with recommended charges.

## **F. Adequacy of Investigations**

### **1. Types and Sources of Investigations**

The 254 files opened during the target period were initiated from various sources, including 175 files that were internally generated from the CME's automated surveillance systems and other routine oversight programs. Thirty-two files were generated from anonymous referrals; 25 files from identified referrals; 10 files from customer complaints; nine files from National Futures Association referrals; and one file from a Division referral. The source of two files was not identified. The 175 files initiated from internal sources included 131 files generated from VDS exception report reviews; 22 files referred from the Globex Control Center; 18 files generated from unknown or non-specified sources; two files referred from trading floor investigators; and one file each from a block trade review and a committee referral.

The Division reviewed 114 of the 224 files closed during the target period for adequacy and thoroughness. The sample reviewed included potential violations relating to, among other things, prearranged trading, violation of the Exchange's dual trading and top step restrictions,

trading ahead of customer orders, broker association violations, misuse of error accounts, and Globex violations. The Division also reviewed several customer complaints. Although investigations were conducted across all contract markets, the majority of investigations were conducted in the Exchange's equity index and interest rate contracts, which account for a significant portion of the Exchange's volume.

## **2. Investigations Referred to a Disciplinary Committee**

The Division found that cases referred to a disciplinary committee for further action were typically complex investigations that involved analysis of substantial amounts of data and frequently involved analysis of several trading days of videotape evidence. The investigations were thorough and well-documented, and the appropriate types of analysis were conducted. The files typically contained pertinent underlying trading documents, summaries of witness interviews, correspondence, computer reports, summaries of the trading activity examined, and detailed Investigation Reports.

The Investigation Reports described the details surrounding an investigation, including how an investigation was initiated, the facts developed during the course of an investigation, staff's analysis and conclusions, and recommendations with respect to charges. The relevant computer reports used for staff's analysis also were attached to Investigation Reports. As stated above, several investigations resulted in disciplinary sanctions involving substantial fines and denials of trading floor privileges for extended periods.

## **3. Investigations Closed by Market Regulation**

Daily investigators use "File Closing Forms" to close investigations. These short forms include a brief description of the investigation conducted. Generally, File Closing Forms are not as detailed as Investigation Reports that go to a disciplinary committee because the matters did not evolve into full-scale investigations. The use of an abbreviated closing form for

investigations that are not going to be pursued further is an acceptable and reasonable practice. However, the Division found some instances where File Closing Forms did not contain sufficient information to permit the Division to make an informed decision regarding the adequacy of the investigation.

For example, the Division reviewed a NASDAQ-100 futures investigation that resulted from numerous complaints concerning the first 30 minutes of trading on a specific date.<sup>39</sup> The File Closing Form noted that all orders from brackets within the relevant time period were reviewed along with “cleared trade data” and profit and loss data for all traders that were active participants in the market. The file included a document that displayed individual brokers’ profits for the first 15 minutes of trading for the date in question, which indicated that four brokers realized what appeared to Division staff as unusually large profits in that short period of time.<sup>40</sup> Videotape from the Exchange’s VTRS system also was reviewed. The File Closing Form concluded, without further explanation, that “[A]s nothing reviewed in the cleared trade data or the videologging images provided evidence to support the allegation, it is recommended that the matter be closed.”<sup>41</sup>

The File Closing Form did not specify the types of trading violations that were considered during the course of the investigation, the types of investigative analyses that were performed or the types of cleared trade data that were reviewed. The Division could not discern from the File Closing Form or other documentation available whether the Exchange further analyzed the profits to determine if they were typical for the market on that particular day, or if they were typical for those particular brokers. Although a direct supervisor may be familiar with

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<sup>39</sup> Case No. 00-17742.

<sup>40</sup> One broker profited by \$360,000; one broker profited by \$275,000 from a 25-lot trade; one broker profited by \$173,000 from two 10-lot trades; and one broker profited by \$139,000 from 115 trades.

<sup>41</sup> A copy of the File Closing Form for Case No. 00-17742 can be found in Appendix 4.

a particular investigation and the analyses conducted, File Closing Forms should contain sufficient information for any reviewer to determine that appropriate analyses were performed.<sup>42</sup>

### **G. File Maintenance**

As noted above, the 114 investigation files examined by the Division generally included pertinent underlying trading documents and either an Investigation Report or File Closing Form. The Division, however, identified two issues with respect to file maintenance that also were raised by the Division in its 1999 Review. First, in the 1999 Review, the Division recommended that the Exchange ensure that investigators prepare a memorandum itemizing interview tapes associated with a particular investigation prior to their storage in a separate area. Because interview tapes are not stored with investigation files, Exchange procedure requires that a memorandum itemizing the tapes associated with a particular investigation be maintained in the respective investigation file. Although some files examined by the Division complied with this procedure, the Division identified several files that did not.<sup>43</sup>

Second, the Division reviewed two investigations that were administratively closed with a recommendation for further monitoring of the members involved.<sup>44</sup> In the 1999 Review, the Division recommended that such monitoring be documented. There was no evidence in either file that the continued monitoring was conducted. In responding to the 1999 recommendation, the Exchange stated that when follow-up monitoring was suggested, a referral memorandum specifying a time period for the monitoring would be directed to the appropriate manager. The Exchange further explained that when the follow-up monitoring was completed, a short

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<sup>42</sup> The Division also found that the File Closing Forms for Case Nos. 01-18366, 00-18229, and 00-17941 stated that the cleared trade data examined did not provide sufficient evidence of trading violations. None of the respective closing forms described the cleared trade data that were examined. Copies of the File Closing Forms for these investigations can be found in Appendix 5.

<sup>43</sup> These files included, among others, Case Nos. 99-17225, 00-17941, 00-18001, and 01-18436.

<sup>44</sup> Case Nos. 00-18204 and 01-18429.

memorandum discussing the results would be written to the file. The Division continues to believe that it is important for the Exchange to document follow-up monitoring when an investigation is administratively closed with such a recommendation.

#### **H. Conclusions and Recommendations**

The Division found that the Exchange maintains an adequate trade practice surveillance program through the use of visual, video, and automated computer surveillance for monitoring and enforcing compliance with Exchange rules. As part of its trade practice surveillance program, the Exchange enforces rules to protect market participants from abusive practices committed by any party acting as an agent for participants.

Market Regulation staff dedicated to trade practice surveillance are led by an experienced management team and successfully develop timely investigations and prosecute disciplinary actions. In this regard, the Division found that investigations referred for disciplinary action involved analysis of substantial amounts of data and also frequently involved detailed analysis of videotape evidence. However, the Division was unable to fully evaluate the adequacy of several investigations that were not referred for disciplinary action because File Closing Forms used to document these investigations did not include sufficient information regarding the types of violations considered or the investigative analysis performed.

The Division also found that investigation files were not always maintained in accordance with Exchange procedure. Specifically, Market Regulation's procedures require that a memorandum itemizing the interview tapes associated with a particular investigation be maintained in the respective investigation file. The Division identified several files that did not comply with this procedure. In addition, the Division found two instances in which investigations were administratively closed with a recommendation for further monitoring of the

subjects. However, there was no evidence in the files documenting whether the follow-up monitoring occurred. Both of these issues were previously brought to the Exchange's attention in the Division's 1999 Review of the CME.

Based on the foregoing, the Division recommends that the Exchange:

- **Ensure that File Closing Forms contain sufficient information for any reviewer to determine that appropriate analyses were performed.**
- **Ensure that memoranda are prepared itemizing the interview tapes associated with a particular file, and that follow-up monitoring of members is documented.**

## **V. DISCIPLINARY PROGRAM**

As stated earlier, Core Principle 2 requires, among other things, that an exchange have the authority to discipline, suspend, or terminate the activities of members or market participants pursuant to clear and fair standards. In this regard, an acceptable program should provide for prompt and effective disciplinary action for any violation that is found to have been committed.

### **A. Disciplinary Committees and Procedures**

On November 15, 2000, the Exchange completed its demutualization plan and converted from an Illinois not-for-profit corporation to a Delaware for-profit corporation. In order to streamline its governance structure and decision-making abilities, the Exchange eliminated several committees, including two disciplinary committees, the Floor Practice Committee (“FPC”) and the Commodity Representative/Customer Complaint Committee (“CRCCC”). The Probable Cause Committee (“PCC”) and the Business Conduct Committee (“BCC”) now serve as the Exchange’s two primary disciplinary committees and have essentially subsumed the roles of the former FPC and CRCCC.

The PCC is a grand jury-type of committee that reviews investigations referred by Market Regulation.<sup>45</sup> Once Market Regulation has forwarded an Investigation Report to the PCC, the case will be assigned to one of two rotating panels. Each panel is comprised of a Chairman, five members, and two voting non-members.<sup>46</sup>

Within 30 days of receiving an Investigation Report, the PCC will determine whether a reasonable basis exists for the issuance of a Notice of Charges based upon violation of Exchange rules. In this connection, if Market Regulation advocates that charges be issued, the

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<sup>45</sup> If probable cause exists to determine that a rule violation is of sufficient magnitude to warrant a direct hearing before the Board of Directors, either Market Regulation or the Chairman of the PCC may file an Investigation Report with the Chairman of the Board. Rule 408.

<sup>46</sup> Rule 407.

Investigation Report will recommend that the rule violation be charged either as a “major” or a “minor” offense.<sup>47</sup> A major offense is punishable by suspension and/or a monetary fine not exceeding \$1,000,000, plus the monetary benefit resulting from the violation, or by expulsion. A minor offense is punishable by suspension not exceeding more than one year and/or by a monetary fine not exceeding \$50,000, plus the monetary benefit resulting from the violation.<sup>48</sup> Additional options available to the PCC, other than directing that a Notice of Charges be issued, include issuing a warning letter or determining that a reasonable basis for a rule violation does not exist.<sup>49</sup>

If the PCC directs that a member be charged, the Notice of Charges must indicate the rule that the respondent is alleged to have violated, describe the conduct, and advise the member of his or her rights, including the opportunity to submit a written answer to the charge within 10 days of receipt of the Notice. The Notice of Charges must further advise the respondent of the committee before which the case will be heard and the time and place for the hearing. A respondent may waive his or her right to a hearing within 10 days of receipt of the Notice of Charges. A respondent’s failure to file a written answer is not considered an admission or denial.<sup>50</sup>

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<sup>47</sup> Major offenses include, among other things, an act which is substantially detrimental to the interest or welfare of the Exchange; being guilty of fraud, any act of bad faith, or dishonest conduct; making or reporting a false or fictitious trade; manipulating prices; acting as both buyer and seller in the same transaction; improperly utilizing or permitting the unauthorized use of Globex; or violation of any rule which cites such violation as a major offense. *See* Rule 432. Minor offenses include, among other things, being guilty of dishonorable or uncommercial conduct, circulating rumors that tend to reflect on the integrity of a contract, or violating any rule of which such violation is not a major offense. *See* Rule 433.

<sup>48</sup> Rule 430.

<sup>49</sup> Rule 408.B. PCC decisions to issue warning letters are primarily based on the gravity of the offense and whether it involves a clear violation of Exchange rules. Similarly, Market Regulation also is authorized, upon appropriate findings, to issue a warning letter rather than referring a matter to the PCC. Warning letters do not constitute either the finding of a rule violation or a penalty. Rule 408.A.

<sup>50</sup> Rule 408.C. and D.



The BCC is responsible for enforcing Exchange rules relating to trading and sales practices, as well as rules relating to trading floor conduct and trading ethics of members and clearing members. Generally, if the PCC directs that a Notice of Charges be issued, the case will be referred to one of four rotating BCC panels for a hearing. Each panel must include a chairman, five members, and two voting non-members.<sup>51</sup> The BCC is authorized, among other things, to: (1) order a member to cease and desist from conduct found to be in violation of Exchange rules; (2) suspend membership privileges, the privilege of acting in the capacity of a Globex terminal operator; or in the case of an employee of a member or a clearing member, suspend trading floor access and/or the right to associate with a member or clearing member for a period not to exceed five years; (3) impose a fine not to exceed \$500,000 per violation, plus the amount of any benefit received as a result of conduct found to be in violation of Exchange rules;<sup>52</sup> and/or (4) order customer restitution, in such amount as warranted by the evidence.<sup>53</sup>

Throughout the entire disciplinary process, Market Regulation will attempt to settle a case. Respondents may agree to settle a case without admitting or denying charged rule violations. Proposed settlements are presented to the BCC for approval.<sup>54</sup> If a settlement is approved, the BCC will file a written decision specifying the Exchange rules alleged to have been violated, a statement that the respondent has accepted the penalty without admission or

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<sup>51</sup> Rule 402.

<sup>52</sup> In November 2000, the Exchange increased the monetary penalty that could be imposed by the BCC from \$100,000 per violation to \$500,000 per violation.

<sup>53</sup> If the BCC determines that a case involves a potential violation that might result in an expulsion or might warrant a penalty in excess of its own authority, the matter will refer the case to the Board for further hearings and decision. Rule 411.

<sup>54</sup> If a respondent presents Market Regulation with an offer of settlement prior to a matter being heard by the PCC, the charging phase of the disciplinary process is passed over and the matter is referred directly to the BCC.

denial, and the penalty to be imposed.<sup>55</sup> If the case cannot be settled, a disciplinary hearing is scheduled.

Prior to a disciplinary hearing, the respondent may examine all evidence relevant to the charges or that is to be relied upon by Market Regulation in presenting its case. Respondents may be represented by legal counsel and are permitted to appear and make oral presentations before the BCC. After the hearing is concluded, the BCC determines guilt or innocence. The BCC Chairman then provides a written report of findings to Market Regulation, the PCC Chairman, and the respondent. The report must include the Notice of Charges; the answer to charges, if any; a summary of evidence produced at the hearing; and a statement of findings regarding each charge, specific rule violations, and penalties, and their effective dates.<sup>56</sup>

A respondent found guilty of an offense, or who is otherwise aggrieved by a decision of Market Regulation or of any committee other than the Arbitration Committee, may appeal to the Board within ten days of any such decision unless specifically prohibited from doing so or the monetary sanction is \$10,000 or less.<sup>57</sup> Unless a respondent demonstrates good cause, appellate hearings are strictly limited to the record of the disciplinary proceeding. The Board may set aside, modify, or amend the decision only if it determines that the decision was arbitrary or not in accordance with Exchange rules; exceeded the committee's authority or jurisdiction; was made without observance of required procedures; or was unsupported by substantial evidence or facts. The Board's decision is final.

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<sup>55</sup> Rule 408.E.

<sup>56</sup> Rule 409.

<sup>57</sup> Rule 417.

## **B. Timeliness of Disciplinary Procedures**

As stated above, Rule 408.B. requires that the PCC determine whether a reasonable basis exists for the issuance of charges based upon a violation of Exchange rules within 30 days of receiving a completed Investigation Report. During the target period, the PCC met four times and reviewed 15 trade practice files that were referred by Market Regulation for disciplinary action. With respect to all 15 files, the PCC made a determination as to whether to charge a member on the same day it formally reviewed the matter. Notices of Charges were promptly issued with respect to 11 of the files. The PCC determined that charges were not warranted with respect to four files comprising two investigations.<sup>58</sup> Thus, the PCC acted well within the 30-day time period prescribed in Rule 408.B.

The Division also reviewed the length of time that elapsed between the date that the PCC determined to issue a Notice of Charges and the date of a settlement. For those matters that resulted in settlement agreements executed during the target period after the PCC directed that charges be issued, the elapsed time between the PCC's determination and the BCC's acceptance of a settlement offer ranged from two to eight months, with an average time period of approximately four months. Therefore, the Exchange moved expeditiously to settle matters and impose sanctions.

## **C. Sanctions Imposed**

To assess the penalties imposed by the Exchange, the Division reviewed Exchange disciplinary committee minutes, Regulation 9.11 disciplinary action notices reflecting disciplinary actions taken during the target period, and all related Exchange disciplinary files. During the six-month target period, the Exchange imposed fines totaling \$720,750 against 151

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<sup>58</sup> Case No. 17328 involved possible noncompetitive trading by three members. In Case No. 00-17672, one of five members involved in possible trading against customer orders was not charged. The PCC found in both cases that there was inconclusive evidence to substantiate the charges against the four members.

individual members, member firms, and clerks. This amount includes fines for various trade practice, recordkeeping, and conduct violations. Trade practice violations resulted in sanctions against 11 members, one clerk, and one Globex terminal operator. Sanctions imposed included \$521,500 in fines, suspensions totaling almost 11 years, and one permanent prohibition from applying for membership at the Exchange and from seeking employment on the Exchange trading floor with any firm associated with the Exchange or any of its divisions. In addition, two members and one clerk were ordered to pay restitution totaling \$33,210 to disadvantaged customers. The trade practice violations included, among other things, trading ahead, noncompetitive trading, prearranged trading, accommodation trading, trading against customer orders, misuse of error accounts, and accepting trades for which a member had not placed orders. Market Regulation also issued 41 warning letters.

The Division reviewed 13 files that were part of eight trade practice cases that resulted in disciplinary action during the target period. Disciplinary sanctions appear to be adequate relative to the conduct being sanctioned and substantial enough to deter future violations. For example, a member was fined \$300,000, barred from reapplying for Exchange membership for 10 years, and suspended from trading floor access for 10 years for accepting trades for which he had not placed orders and allowing a non-member clerk to place those trades in his account.<sup>59</sup> In addition, the member's clerk was fined \$10,000 and ordered to pay restitution of \$24,625.<sup>60</sup> In another matter that involved noncompetitive trading, a member was fined \$100,000, ordered to pay \$6,125 in restitution, and was permanently barred from applying for future Exchange membership or seeking employment on the Exchange trading floor with any firm associated with the Exchange

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<sup>59</sup> Case No. 00-17512; File No. 18259. A copy of the Investigation Report for this matter can be found in Appendix 6.

<sup>60</sup> Case No. 00-17512; File No. 17512. A copy of the Investigation Report for this matter can be found in Appendix 7.

or its divisions.<sup>61</sup> Fines totaling \$11,500 also were levied against two other members as part of this same matter.

Other examples of significant sanctions issued during the target period include a \$25,000 fine and a five-day suspension for prearranged trading;<sup>62</sup> two \$15,000 fines, a 15-day suspension and a six-day suspension against two members for noncompetitive trading;<sup>63</sup> a \$15,000 fine, a 10-day suspension of floor privileges, a two-year suspension of floor broker privileges, and restitution in the amount of \$2,460 for confirming trades at prices other than those at which they were executed;<sup>64</sup> and a \$15,000 fine and a four-month suspension for prearranged trading and violating dual trading restrictions.<sup>65</sup>

The Division also found that disciplinary matters were generally well documented. However, the Division identified two matters in which the PCC determined not to accept Market Regulation's recommendation to issue charges for a particular rule violation or reduced the recommended charges from major to minor offenses without explanation in the relevant case file or PCC minutes. In this regard, Rule 408.B. requires that all PCC determinations "shall be in writing, including reasons thereof, all of which shall become part of the investigation file."

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<sup>61</sup> Case No. 00-17530; File No. 17530. *See* Section IV.B. at p. 25 for a more detailed description of the matter.

The \$300,000 fine imposed in Case No. 00-17512 and the \$100,000 fine and \$6,125 in customer restitution imposed in Case No 00-17530 are uncollected. The two individuals against whom the penalties were imposed both leased their memberships and have been barred from the Exchange. In addition, the \$10,000 fine and the \$24,625 in restitution levied against the clerk in Case No. 17512 are also uncollected. The clerk has been barred from the trading floor until the fine and restitution have been paid.

<sup>62</sup> Case No. 00-17293; File No. 17294. In addition, subsequent to the target period, a second member involved in this case was fined \$40,000, suspended for 20 days, and banned from filling customer orders for one year. *See* Section IV.B. at p. 26 for further discussion of this investigation.

<sup>63</sup> Case No. 99-17223; File Nos. 17223 and 18015. A copy of the Investigation report for these matters can be found in Appendix 8.

<sup>64</sup> Case No. 00-17321; File No. 17321. In addition, subsequent to the target period, another member involved in this case was fined \$2,500 and suspended for 13 days. A copy of the Investigation Report for this matter can be found in Appendix 9.

<sup>65</sup> Case No. 00-17529; File No. 17529. A copy of the Investigation Report for this matter can be found in Appendix 10.

In the first matter, Market Regulation recommended that a broker be charged with four major violations of Rule 539 (Prearranged Trades Prohibited) and two major violations of Rule 541 (Trading Restrictions Respecting the S&P 500 Stock Price Index Futures Contract).<sup>66</sup> The PCC charged the broker with one major and three minor violations of Rule 539 and issued no charges with respect to violation of Rule 541. There is no documentation in the case file regarding the PCC's determination nor do the PCC's minutes indicate why the PCC did not fully accept Market Regulation's recommendation. In the second matter, Market Regulation recommended that a broker be charged with two major violations of Rule 539 and two major violations of Rule 541.<sup>67</sup> The PCC charged the broker with two minor violations of Rule 539 and one major violation of Rule 541. Again, neither the case file nor the PCC's minutes indicate why the PCC did not fully accept Market Regulation's recommendation. Although, as described above, both of these cases resulted in the imposition of sanctions for the remaining charges, the Exchange should document the PCC's rationale in those instances where staff's recommendations are not followed.

#### **D. Conclusions and Recommendations**

Based upon its review the Division found that the Exchange maintains an adequate disciplinary program. The PCC promptly determines whether to issue charges, and when charges are issued, cases are promptly referred to the BCC.

During the target period, the Exchange assessed \$521,500 in fines; permanently prohibited an individual from applying for future Exchange membership and from seeking employment on the Exchange trading floor with any firm associated with the Exchange or any of its divisions; and imposed suspensions totaling almost 11 years for trade practice violations such

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<sup>66</sup> Case No. 00-17293.

<sup>67</sup> Case No. 17529.

as noncompetitive trading, trading ahead, prearranged trading, accommodation trading, trading against customer orders, misuse of error accounts, and accepting trades for which a member had not placed orders. In addition, members were ordered to pay \$33,210 in customer restitution. The penalties imposed appear reasonable relative to the conduct being sanctioned.

However, the Division identified two instances when the PCC determined not to accept Market Regulation's recommendation to issue charges for a particular rule violation or reduced the recommended charges from major to minor offenses, without explanation in the relevant case file or PCC minutes.

Based on the foregoing, the Division recommends that the Exchange:

- **Document the PCC's reasoning for not issuing a particular charge or reducing charges that are recommended by Market Regulation staff.**