

**RULE ENFORCEMENT REVIEW  
OF THE  
KANSAS CITY BOARD OF TRADE**



**Division of Market Oversight**

**June 16, 2006**

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# RULE ENFORCEMENT REVIEW OF THE KANSAS CITY BOARD OF TRADE

## I. INTRODUCTION

The Division of Market Oversight (“Division”) has completed a rule enforcement review of the self-regulatory programs at the Kansas City Board of Trade (“KCBT” or “Exchange”) for compliance with applicable core principles under Section 5(d) of the Commodity Exchange Act (“Act”) and Part 38 of the Commission’s regulations.<sup>1</sup> The Division’s review covered core principles that relate to the Exchange’s market surveillance, audit trail, trade practice surveillance, disciplinary and dispute resolution programs. The review focused on the period of August 1, 2004 through August 1, 2005 (“target period”).<sup>2</sup>

The Division evaluated KCBT compliance with the following core principles:

- **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 4 – *Monitoring of Trading* and Core Principle 5 – *Position Limitations or Accountability***: relate to an exchange’s program to prevent manipulation, price distortion, and disruptions of the delivery or cash settlement process, and for enforcing its speculative position limits and position accountability rules;

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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> The Division’s prior rule enforcement review of the KCBT was presented to the Commission on February 23, 2003.

- **Core Principle 10 – Trade Information and Core Principle 17 – Recordkeeping:** relate 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, and the maintenance and safe storage of trade-related records; and
- **Core Principle 13 – Dispute Resolution:** relates to fair and equitable dispute resolution procedures for customers and member-to-member disputes.<sup>3</sup>

To assess KCBT compliance with these core principles, Division staff examined Exchange compliance procedures and numerous documents used by the Exchange’s Department of Audits & Investigations (“A&I”) in performing its compliance and surveillance responsibilities. These documents included, among other things:

- computer reports and other documentation used routinely for trade practice surveillance, market surveillance and audit trail rule enforcement;
- trade practice investigation, audit trail and disciplinary case files;
- trade practice investigation, floor surveillance, and disciplinary logs;
- contract expiration files;
- minutes of arbitration, disciplinary committee, and Board of Directors (“Board”) meetings held during the target period; and
- compliance manuals and guidelines.

The Division also interviewed A&I officials with respect to the operation of the Exchange’s self-regulatory programs.<sup>4</sup>

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<sup>3</sup> Appendix B to Part 38 of the Commission’s regulations provides guidance concerning the core principles with which a designated contract market must comply to maintain its designation. In addition, Appendix B provides acceptable practices for several of the core principles. Although the acceptable practices establish non-exclusive safe harbors, they do not establish a mandatory means of compliance with the core principles. Appendix B provides acceptable practices for Core Principles 2, 10, 13, and 17; however, acceptable practices are not set forth for Core Principle 12. In promulgating Part 38, the Commission reserved the authority to adopt acceptable practices for Core Principle 12 at a later date.

<sup>4</sup> A copy of the October 26-27, 2005 transcript of the interview can be found in Appendix 1.

The Division provided the Exchange an opportunity to review and comment on a draft of this report on May 17, 2006. On May 23, 2006, Division staff conducted an exit conference with KCBT officials to discuss the report's findings and recommendations.

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

### **A. Compliance Staff**

#### **Findings**

- The Exchange's compliance department, the Department of Audits and Investigations, consists of two staff members, the Vice President-Compliance and the Assistant Vice President –Compliance. These staff members are responsible for carrying out all of the Exchange's self-regulatory obligations, including market surveillance, trade practice surveillance, audit trail rule enforcement and disciplinary programs, as well as financial surveillance.
- Although the Vice President and Assistant Vice President have extensive compliance experience, the multiple daily surveillance activities that must be performed by A&I staff to meet its self-regulatory responsibilities are placing a strain on staff in keeping pace with the Exchange's record volume. This is evidenced by the need for regular increased assistance by the Exchange's accountant to conduct routine trade practice surveillance.

#### **Recommendation**

- **The Exchange should increase its A&I staffing to a level that would keep pace with growth in trading activity to enable the Exchange to efficiently and effectively perform routine surveillance activities.**

### **B. Market Surveillance**

#### **Findings**

- The Exchange monitors prices, volume, open interest, spread relationships, deliverable supplies and market news on a daily basis. In addition, A&I keeps informed of cash market developments and delivery intentions.
- The Exchange heightens surveillance during the expiring contract month, beginning prior to first notice day. Surveillance of expiring contracts typically focuses on potential position concentrations, deliverable supplies, and the relationship between open interest and deliverable supplies.

- The Exchange also has adequate procedures for monitoring reportable trader positions, enforcing speculative position limits, and identifying exchanges of futures for physicals and exchanges of futures for risk transactions that warrant further investigation.

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

### **C. Audit Trail**

#### **Findings**

- The Exchange uses transaction and Time and Sales data in its automated surveillance system to monitor for potential trading violations, and to provide evidence of any rule violations. The Exchange's audit trail program includes quarterly audit trail reviews of clearing firms and floor members to assess compliance with order ticket and trading card recordation requirements. The Exchange also routinely monitors compliance with its one-minute trade timing requirement.
- Floor members and clearing firms demonstrated a high level of compliance with Exchange audit trail rules during the target period. In addition, audit trail reviews were thorough, well documented and completed in a timely manner.
- Back-up tapes containing confidential trade register data are stored each night, unencrypted, in an unsecured off-site location. In addition, restore procedures and tapes containing historical trade register and Time and Sales data are not periodically tested for possible degradation or data loss.

#### **Recommendations**

- **The Exchange should encrypt the trade data back-up tapes taken off-site each night, or alternatively, deposit them in a secure off-site location; and**
- **The Exchange should periodically test historical trade data and Time and Sales back-up tapes for degradation or data loss, and its restore procedures for expeditious and complete system recovery.**

## **D. Trade Practice Surveillance**

### **Findings**

- The Exchange reviews its trade register, the Time Audit Report, on a daily basis and examines all exceptions identified on the report for possible violations. The TAR shows possible trade practice violations by performing edit functions based on predetermined parameters designed to identify specific types of trading abuses, such as trading ahead, accommodation trading and wash trading.
- The Exchange targets its more active members for routine trade practice investigations, examining three to five days of trading activity for those members annually. In addition, Exchange staff conducts floor surveillance periodically each day to monitor for trading violations.
- The Exchange's investigations were completed in a timely manner, well documented, and, in large part, thorough. The Exchange also improved the quality of its investigations by expanding the scope of investigations to examine for possible patterns of violations, particularly when the subject member has a prior disciplinary history.

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

## **E. Disciplinary Matters**

### **Findings**

- The Exchange's Complaint Committee considered three cases during the target period. Two cases involved audit trail recordkeeping violations by two floor members, and one involved inaccurate reporting of open interest by a member firm. The two members were fined \$100 and \$200, respectively, and the firm was fined \$500. The Exchange also issued 23 reminder letters and 12 warning letters, primarily for trading card recordkeeping and trade timing violations.
- The member who received a \$200 fine had been issued one previous warning letter regarding audit trail violations, while the member who received a \$100 fine was issued consecutive warning letters in the two months prior to the sanction. In addition, the latter member received reminder and warning letters in the two previous years. In view of this member's history of audit trail violations, a larger sanction was warranted.



## **Recommendation**

- **Impose sanctions that serve as an effective deterrent against members who repeatedly violate the Exchange's audit trail rules.**

## **F. Dispute Resolution**

### **Findings**

- Exchange rules provide customers with voluntary procedures for arbitration that are fundamentally fair and equitable. Each party has the right to counsel and each party receives adequate notice of claims presented against them and an opportunity to be heard on all claims, defenses, and counterclaims. KCBT's arbitration procedures require a prompt hearing and authorize prompt, written, final settlement awards that are not subject to appeal within the Exchange. KCBT also provides arbitration procedures for member-to-member disputes.
- The one customer arbitration case heard during the target period was handled in conformance with Exchange rules and procedures, and was adequately documented. There were no member-to-member arbitrations during the target period.

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

### III. COMPLIANCE STAFF

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

**The board of trade shall monitor and enforce compliance with 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.**

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.

Currently, A&I consists of two staff members, the Vice President-Compliance, who reports to the President and CEO of the Exchange, and the Assistant Vice President – Compliance. These staff members are responsible for administering the Exchange's market surveillance, trade practice surveillance, and audit trail and disciplinary programs, as well as the Exchange's financial surveillance program. The Exchange's accountant assists A&I staff on a part-time basis. The Vice President and Assistant Vice President have extensive compliance experience. The Vice President has 18 years of Exchange experience, and the Assistant Vice President has been at the Exchange for 15 years. Each has served in his current position for the past eight years.

With respect to market surveillance activities, the Vice President is primarily responsible for surveillance of expiring wheat futures and options, and monitoring of reportable positions. The Assistant Vice President is primarily responsible for daily market surveillance activities, such as the monitoring of price changes, volume, open interest and spread relationships.

With respect to trade practice surveillance and audit trail rule enforcement, the Vice President is responsible for monitoring the wheat options contract (for both open outcry and electronic trading), the electronic wheat futures contract, and the Value Line futures and options contracts.<sup>5</sup> The Assistant Vice President is responsible for monitoring the wheat futures contract. The Exchange's accountant regularly assists A&I staff by conducting audit trail reviews and trade practice investigations of a routine nature. However, more recently, beginning in March 2006, due to the demands of increased trading volume, the accountant has started reviewing trading activity in wheat options and the Exchange's "Outtrade Report" to assist A&I staff with their daily surveillance.

The Division believes that the multiple daily surveillance activities that must be performed by A&I staff to meet its self-regulatory responsibilities, including market, trade practice and financial surveillance, are placing a significant strain on A&I staff with respect to keeping pace with the Exchange's steadily increasing trading volume.<sup>6</sup> The recent need for increased assistance by the Exchange's accountant to satisfy routine trade practice surveillance obligations, such as monitoring of wheat options trading, demonstrates the necessity for

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<sup>5</sup> KCBT lists contracts in hard red winter wheat and Value Line futures and options for both open outcry and electronic trading. Since December 12, 2004, Value Line futures and options have been traded exclusively on the e-cbot electronic platform. During the target period, wheat futures and options were pit traded and listed on e-cbot during after hours trading. On August 1, 2006, wheat futures trading will be expanded to include side-by-side (electronic and pit) trading.

<sup>6</sup> In 2005, KCBT set an all-time record for trading volume (3,953,536 contracts), exceeding the previous record set in 2002 by 19 percent. Further, for the tenth time in 12 years, the KCBT set a new annual volume record in the wheat futures by breaking the previous annual record in 2004 by 30 percent. That trend has continued in 2006, with April volume exceeding April 2005 volume by 56 percent. Overall, year-to-date volume through April 2006 was up nearly 58 percent.

additional A&I staff. Additional staff would enhance the overall effectiveness and efficiency of the Exchange's compliance department, and allow it to meet the demands of increasing volume.

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

- **Increase its A&I staffing to a level that would keep pace with growth in trading activity to enable the Exchange to efficiently and effectively perform routine surveillance activities.**

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

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

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

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

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

Pursuant to the acceptable practices set forth in Appendix B to Part 38 of the Commission's regulations, an acceptable market surveillance program should regularly collect and evaluate market data to determine whether markets are responding to the forces of supply and demand. An exchange also should have routine access to the positions and trading of its market participants. To diminish potential expiration problems that may arise from excessively large speculative positions, an exchange may need to establish spot-month speculative limits for some commodities. Such position limits are not necessary for markets where the threat of excessive speculation or manipulation is very low. For some contracts, such as financial instruments, an exchange may provide for position accountability in lieu of position limits.

##### **A. Overview of Routine Surveillance**

A&I's routine market surveillance activities include daily monitoring of prices, volume, open interest, and deliverable supplies where applicable. A&I examines the "Volume and Open Interest by FCM Report" ("Volume and Open Interest Report") for each contract on a daily basis. The report lists pit trades and trades off the centralized market, such as exchange of futures for physicals ("EFP") transactions and transfer trades, option exercises, and ending gross

long and short positions for all clearing members in all months. The report, which also includes codes that highlight for review any open position changes greater than the clearing member's daily volume, is reviewed for any significant change in open interest.<sup>7</sup> A&I analyzes significant changes to determine possible reasons for the change and any market impact. Staff also contacts the respective clearing member if any questions remain as to whether the problem was resolved satisfactorily or if further action is necessary. A&I notes the amounts of increases or decreases in the clearing member's open positions on the Volume and Open Interest Report, and provides a brief explanation from the clearing member.<sup>8</sup>

Price changes are reviewed daily. A&I reviews daily price changes for KCBT contracts, as well as cumulative price changes dating back to expiration of the preceding contract, and the spread differential between the nearby and each deferred month. In addition, in connection with surveillance of its wheat contract, staff tracks daily price movements of wheat futures at the Chicago Board of Trade and Minneapolis Grain Exchange, and the spreads between those markets and the KCBT contract. Staff also monitors price movements and spreads in Value Line futures against the Value Line Spot Index, S&P 500 future and spot indexes, New York Stock Exchange Composite Index future and spot indexes, and the Dow Jones future and spot indices.

Finally, KCBT reviews daily and weekly stock reports to monitor deliverable supplies of wheat. A&I receives a "Daily Stock Report" from its 15 "regular elevators," which shows the

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<sup>7</sup> A significant change includes an abrupt increase or decrease in the total open interest in any clearing member's positions or an abrupt switch from a long to a short position, or vice versa.

<sup>8</sup> During the target period, A&I opened one investigation, #SP0503, that resulted from a review of the Volume and Open Interest Report. The investigation revealed that a clearing member had a large reduction in its July 2005 wheat futures position, in excess of its daily volume for July 11, 2005. A&I found that the clearing member accepted give-up transfer trades totaling 70 contracts from another clearing member and failed to properly offset these contracts on a timely basis. As a result, open interest in the July 2005 contract was overstated by 70 contracts, or 18%, on July 11, two days before the last trading day. A&I referred the reporting violation to the Complaint Committee and the firm was fined \$500. See pp. 39-42 for a discussion of the Exchange's disciplinary program.

gross amount of wheat and other commodities either held in storage or for which warehouse receipts are held as of the previous day's close of business.<sup>9</sup> The gross amount is posted on the trading floor each morning, along with the increase or decrease from the previous business day. The regular elevators also provide a "Weekly Deliverable Stocks Report." A&I uses to this report to determine if any discrepancies exist between the daily and weekly statistics. If discrepancies are identified, A&I reports them for follow-up to the KCBT's President and CEO.

A&I also reviews the Weekly Deliverable Stocks Reports, Daily Stock Reports, daily railroad receipts and shipments, and registered warehouse receipts to verify the deliverable supply of wheat. A&I contacts the parties or members with outstanding warehouse receipts in order to confirm their status. In addition, A&I compiles wheat stocks information, and issues a report every Tuesday indicating the total deliverable grades, total non-deliverable grades, and total Commodity Credit Corporation ("CCC") stocks for the Hutchinson and Kansas City elevators.<sup>10</sup>

## **B. Surveillance of Expiring Contracts**

### **1. Expiring Futures**

To ensure orderly liquidations, A&I heightens surveillance of open positions in expiring contracts, beginning a few days before the first notice day of a wheat future, i.e., the last business day of the month preceding the delivery month. A&I reviews the house and customer positions held by each clearing member and prepares a spreadsheet for the three largest long and short position holders (and any other clearing members with positions of 100 contracts or more), and

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<sup>9</sup> Regular elevators are those elevators that have satisfied the Exchange's requirements for facilities, capacity, location, and financing, and have been approved for delivery of hard red winter wheat against the futures contract.

<sup>10</sup> The CCC, a government-owned entity affiliated with the United States Department of Agriculture, assists farmers and offers price support programs, foreign sales programs, and export credit programs for agricultural commodities.

their respective percentage of open interest. A&I monitors these clearing members throughout the expiration period until their positions are liquidated.

On first notice day of the wheat futures contract, A&I sends liquidation notice letters to clearing members reminding them of the delivery date and the last trading day of the expiring month.<sup>11</sup> Throughout the expiring month, A&I routinely contacts clearing members and other position holders about their intentions to make or take delivery, and reminds them that an orderly liquidation is expected. In addition, A&I routinely performs an “economic justification” test, calculating the difference between the cost to procure wheat through the delivery process and the cash market. Staff reviews current market prices and spread trading activity to determine which would be more economical given the current market conditions.

## **2. Expiring Options**

For wheat and Value Line option contracts, A&I reviews an “In-the-Money Report Summary” that it receives from the KCBT Clearing Corporation (“Clearing Corporation”) a week prior to expiration. The report shows the clearing members, number of long and short option positions, house or customer designation, and the settlement price of the expiring contract. A&I sends liquidation letters to the clearing members with long in-the-money positions one week before the last trading day of the expiring option month. A&I requires clearing members to sign and date all liquidation letters, acknowledging that they have received the notification. The purpose of the letter is to remind clearing members that, pursuant to KCBT Rules 2515.04 and 2615.04, in-the-money option positions are exercised automatically unless instructions to the contrary are delivered to the Clearing Corporation by 4:00 p.m. the day the letter is received.

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<sup>11</sup> The Value Line futures contract is cash-settled; therefore, liquidation letters are not sent, and delivery-related issues associated with its expiration do not occur.



A&I also reviews an “Exercise – Delivery Trade Register Report” that lists options that were exercised on the previous business day. The report identifies the clearing member, premium, settlement price, quantity bought and/or sold, and the dollar amount exercised. A&I reviews the report to ensure that the options were properly exercised, particularly those exercised on the last trading day. During the target period, all in-the-money options were exercised properly or were automatically exercised pursuant to Exchange rules.

### **3. Expiration Files**

A&I documents its surveillance of expiring months in contract expiration files. The expiration files contain price change and open interest liquidation spreadsheets, spreadsheets listing the largest long and short position holders, copies of liquidation letters sent to clearing members, delivery notices, in-the-money summaries, reports of exercises and memos detailing phone conversations with relevant parties.

The Division reviewed the five expiration files for wheat futures during the target period, and found that the files were well-documented and reflective of the surveillance activities conducted.

#### **C. Large Trader Reporting and Enforcement of Speculative Position Limits, Hedge Exemptions, and Position Accountability**

KCBT rules concerning speculative limits prescribe the maximum number of net futures-equivalent contracts (futures and options) which any one person or entity may own or control on the same side of the market without an approved exemption. The Exchange has adopted the federal speculative limits set forth in Commission Regulation 150.2 for wheat futures and

options.<sup>12</sup> KCBT Rule 2415.02 and Resolution 26-2621.00-02 prescribe the position limits for Value Line futures and options, respectively.

A&I monitors speculative position limits and reportable positions by obtaining weekly large trader position reports from Division surveillance staff in Chicago via encrypted email. The reports list, by owner, each account that has a reportable position, as well as the filing firm, account type indicator, future month and year, position long and short, and for options, put or call indicator, strike price, delta, and delta-adjusted long and short position. Additional reports can be produced more frequently, upon request. A&I reviews reportable positions to ensure that traders do not exceed speculative position limits, to identify possible concentrations of positions that may disrupt the market, and to monitor the activity of the largest traders in the markets. In addition, A&I obtains copies of the CFTC Form 102 for new reportable accounts, and CFTC Form 40 (Statement of Reporting Trader) from Division surveillance staff, as needed.

There were no speculative limit violations during the target period.<sup>13</sup>

#### **D. Exchange of Futures for Physicals and Exchange of Futures for Risk Transactions**

KCBT rules allow for two types of trades to be executed off the centralized market -- transactions in futures made either in connection with EFPs or for the purpose of establishing the price of cash commodities, and, since 2002, Exchange of Futures for Risk (“EFR”) transactions, which involve the exchange of futures contracts for or in connection with over-the-counter (“OTC”) derivative transactions.<sup>14</sup> To ensure that EFPs and EFRs are transacted in accordance

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<sup>12</sup> Under federal speculative limits, the Commission is responsible for approving hedge exemptions for the wheat contract; however, the Exchange obtains copies of the approval letters, when needed.

<sup>13</sup> The KCBT does not have position accountability rules since speculative position limits apply to each contract.

<sup>14</sup> See KCBT Rule 1128.00 (allowing EFP transactions), Rule 1128.01 (specifying EFP clearing requirements), and Rule 1128.02 (requiring the production of EFP documentation upon request). See also, KCBT Rule 1129.00

with Exchange rules, A&I examines its trade register, the Time Audit Report (“TAR”), on a daily basis. A&I reviews the report for EFPs or EFRs that may warrant further investigation, such as those that have the same clearing firm and account number on both sides of the transaction, are unusually large, or are priced outside the daily trading range. If any of these elements are identified, A&I contacts the clearing member and/or account owner to determine whether the transaction was bona fide, and obtains supporting documentation to verify the transference of the commodity.

During the target period, A&I’s review of the TAR revealed no EFPs that warranted further investigation. In this connection, Division staff conducted an independent review of EFPs using cleared trade data on 12 randomly selected days during the target period and, similarly, did not find any EFPs that appeared suspicious or otherwise warranted further investigation.

For the first two years of EFR trading, A&I requested documentation for all EFR transactions to confirm the OTC components, the validity of the documents (confirmation or master swap agreement), and the parties involved. In the past few years and during the target period, A&I has incorporated EFR surveillance into its daily review of the TAR. A&I obtained documentation on 12 EFR transactions during the target period. The Division’s review of the files indicated that appropriate documentation was obtained, including swap transaction confirmations, equity runs, order tickets, and correspondence between the parties, including e-mail communications.

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(allowing EFR transactions), Rule 1129.01 (specifying EFR clearing requirements), and Rule 1129.02 (requiring the production of EFR documentation upon request).

## **E. Conclusions and Recommendations**

The Division found that the Exchange maintains an adequate market surveillance program. The Exchange monitors prices, volume, open interest, spread relationships, deliverable supplies and market news on a daily basis. In addition, A&I keeps informed of cash market developments and delivery intentions. Surveillance of expiring contracts typically focuses on position concentrations, deliverable supplies, and the relationship between open interest and deliverable supplies. A&I works closely with Division surveillance staff, particularly during expiring months, to ensure an orderly liquidation. The Exchange also has adequate procedures for monitoring reportable traders, enforcing speculative position limit rules and identifying suspicious EFPs and EFRs for follow-up.

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

## V. AUDIT TRAIL

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

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

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

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

Pursuant to the acceptable practices set forth in Appendix B to Part 38 of the Commission's regulations, an effective contract market audit trail should capture and retain sufficient trade-related information to permit contract market staff to detect trading abuses and 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 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.

Commission Regulation 1.31 governs the manner in which an exchange is required to maintain trade-related records. The regulation mandates that all records required to be kept under the Act or Commission regulations be maintained for five years and be readily accessible during the first two years. Most categories of required records may be stored on either micrographic or electronic storage media for the full five-year maintenance period. However,

trading cards, documents on which trade information is originally recorded in writing, and order tickets must be retained in hard copy for five years.

## **A. Trade Recordation Requirements**

### **1. Floor Order Tickets**

At KCBT, orders are either written on floor order tickets by clearing firm staff or electronically received at firm trading floor desks, via the Trade Order Processing System (“TOPS”), an industry-wide order routing system.<sup>15</sup> Order tickets are then handed to floor brokers or order instructions are flashed, *i.e.*, hand-signaled, into the pit. Upon execution, a floor broker either records fill information on the order ticket or flashes fill information back to the firm’s desk. The Exchange requires an order ticket to include an account identifier, order number, entry timestamp indicating when the order was received on the floor, and exit timestamp indicating when the filled order was returned or reported back to a firm’s desk.<sup>16</sup>

### **2. Trading Cards**

KCBT also requires each member to record all trade executions for customer and personal accounts on trading cards promptly upon the purchase or sale of any contract.<sup>17</sup> Floor members record trades on double-sided cards, with buys on one side and sells on the other. The card must contain the member’s trading initials, clearing firm code, date, time of trade execution to the nearest minute, quantity, commodity, month, price, opposite member and clearing firm initials, and for option contracts, premium, strike price, and put or call indicator. Members must

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<sup>15</sup> Eight of the Exchange’s 20 clearing firms receive orders via TOPS. Each firm has a TOPS machine at its trading floor desk that prints orders received from various office locations in the form of an order ticket. Another clearing firm has a TOPS machine to only send orders to Chicago; it does not receive orders for KCBT contracts.

<sup>16</sup> KCBT Resolution 11-1130.00-1.

<sup>17</sup> KCBT Rule 1115.00.

record their trades in non-erasable ink, in sequential order, and without skipping lines between trades. In addition, a line must be drawn to separate trades executed during the opening and closing periods from other trades.

Three different types of trading cards are used at the Exchange: (1) personal trading cards; (2) brokerage cards; and (3) master cards. Personal trading cards, which are used by Exchange members to record personal trades, are pre-printed with the respective member's trading initials and card sequence numbers. Members must mark through any remaining unused lines on a personal trading card before starting a new card. Brokerage cards, which do not contain pre-printed sequence numbers, are used to record executions for house and customer accounts. A broker uses a separate brokerage card for each clearing firm for which he or she fills house or customer orders. Finally, a broker also may record all house and customer fills together on a master card and then have the required trade information transcribed onto separate broker cards, one per clearing firm. Master cards are used by brokers who fill orders for numerous clearing firms and prefer not to carry or hold separate cards for each firm. Only two brokers used master cards during the target period.

### **3. Trading Card Collection**

Personal trading cards and brokerage cards must be submitted to clearing firms no later than 15 minutes after each 30-minute trading interval and promptly timestamped upon collection.<sup>18</sup> Clearing firms must submit trades to the Clearing Corporation within 60 minutes after each 30-minute interval. The clearing system matches trades that agree on quantity,

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<sup>18</sup> KCBT Rule 1115.02. Master cards are not subject to Exchange collection requirements because only data recorded on personal trading cards and brokerage cards are entered into the clearing system. However, pursuant to Commission Regulation 1.31, members who use master cards must save the cards for five years and produce the cards upon request.

brokers, month, price, and clearing firms as soon as both sides are entered. Clearing firms can enter trades and correct errors until the first reconciliation report listing all matched trades is distributed, approximately 45 minutes after the close of each contract. In addition to the reconciliation report, clearing firms are given a list of trades that cannot be matched due to a data inconsistency (“cutout trades”). The Clearing Corporation busts all cutout trades that are not resolved by 4:00 p.m., the end of the final reconciliation process. However, cutout trades that are busted may be resolved prior to the opening on the following business day “as of” the original trade date.

The Clearing Corporation provides A&I with a “Daily Out-Trade Audit Report” (“Outtrade Report”) that contains a record of all cutout trades, corrections, and busted trades from the previous business day. A&I reviews this report daily to ensure that trade corrections were not made to facilitate non-competitive or fictitious trades. A&I also reviews all as-of trades by comparing the trade price to the previous day’s Time and Sales Report (“Time and Sales”).

## **B. Audit Trail Reviews**

### **1. Full and Limited-Scope Reviews**

KCBT conducts quarterly reviews of order tickets and trading cards (“audit trail reviews”) to monitor compliance with its trade recordation requirements. Audit trail reviews alternate between full-scope and limited-scope reviews. Full-scope reviews encompass all Exchange clearing firms and floor members.<sup>19</sup> A&I endeavors to perform a full-scope review on each member annually. Limited-scope reviews primarily focus on clearing firms and floor

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<sup>19</sup> When KCBT initiates an audit trail review, one review is opened to examine clearing firms and a separate review is opened to examine floor members.



members who received a previous reminder or warning letter, or were referred to the Complaint Committee in the previous full-scope audit trail review.

For both full-scope and limited-scope reviews, A&I randomly selects a three-day period and examines all trading cards and order tickets prepared by the firms and floor members under review. If A&I finds that a clearing firm's or floor member's error rate exceeds five percent of the cards or transactions examined, A&I issues a reminder or warning letter, or refers the matter to the Complaint Committee for possible disciplinary action.<sup>20</sup>

## **2. Member Compliance Rates**

During the target period, A&I conducted two full-scope and one limited-scope audit trail reviews in which it examined a total of 4,296 order tickets prepared by 20 clearing firms and 3,769 trading cards (2,124 brokerage cards and 1,645 personal trading cards) prepared by 40 floor members. The Division examined the three review's files, and found a high level of member compliance with KCBT's trade recordation requirements. Specifically, all of the order tickets examined contained order numbers and account identifiers; 4,241 of the order tickets (99 percent) included both entry and exit timestamps; and 98 percent of the trading cards were promptly timestamped upon collection.

With respect to floor members' brokerage and personal trading cards, the reviews indicated that all of the trading cards were written in the required non-erasable ink. In addition, 99 percent of the cards had no skipped lines, and properly identified the opening and closing periods with a drawn line. Executing clearing firms were recorded on 98 percent of the cards, 97

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<sup>20</sup> A&I generally issues a reminder letter for a first offense if a member's deficiency level is between five and ten percent, or a warning letter if the member's deficiency level exceeds ten percent. A second offense for the same violation within one year generally results in a warning letter. If a member continues to violate audit trail rules following receipt of a warning letter, A&I refers that member to the Complaint Committee.

percent of the cards were collected by the clearing member within 15 minutes of each 30-minute trading interval and 96 percent of the cards included the date, commodity, price, quantity, time, opposite clearing firm, and put or call indicator for option trades. In addition, 99 percent of the personal trading cards reviewed were preprinted with members' trading initials, and trading card sequence numbers and 98 percent had unused lines properly marked through. Finally, 99 percent of the personal trading cards were properly started after each 30-minute trading interval.

The Division's examination of KCBT's audit trail reviews found that the files were thorough, well documented, and completed in a timely manner. The files included copies of all original floor orders, brokerage cards, and personal trading cards examined during the reviews, worksheets, and copies of all reminder and warning letters. Each file also included a form that showed the start date, completion date, final report date, and the dates of any resulting disciplinary actions.

### **C. Trade Timing**

As noted above, KCBT requires that the buying and selling members manually record the time of each pit trade to the nearest minute on his or her trading card. KCBT enforces this requirement by reviewing its daily trade register, the TAR, which contains various codes indicating possible trade timing errors.<sup>21</sup>

The TAR identifies seven types of timing errors that may be indicative of a trade timing violation. The first error is "Bought Side-No Trade" ("B-NT"). The TAR compares the time recorded by the buyer to the Time and Sales listing. If no trade is indicated on Time and Sales at the time recorded by the buyer, or within one minute preceding or one minute following that time, the trade is coded B-NT. The second error is "Sold Side-No Trade" ("S-NT"). The

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<sup>21</sup> A sample copy of the TAR can be found in Appendix 2.

computer program follows the same procedures as for a B-NT, but compares the seller's recorded time to the prices recorded on Time and Sales. The third error, "No Quote at This Price" ("No Quote"), is a combination of a B-NT and S-NT. Thus, a trade is coded as a No Quote if the trade does not appear on Time and Sales within a minute of the time recorded by either the buyer or the seller.

The fourth type of timing error identified on the TAR is "Time Out of Limits" ("TOL"). A trade is coded TOL if the times recorded by both the buyer and the seller are marked as accurate by the system but there is more than two minutes between the two times. The fifth error noted on the TAR is "Bought Side-Untimed Trade" ("B-UT"). A trade is coded B-UT if the buyer fails to record a time for the trade on his or her trading card. Similarly, a trade is coded as "Sold Side-Untimed Trade" ("S-UT") if the seller fails to record a time for a trade on his or her trading card. The final timing error, "Invalid Spread," refers to a spread differential that does not appear on Time and Sales within the minute or minute preceding or following the trade time recorded by either the buyer or seller.

A&I reviews the TAR daily and compiles monthly statistics of each member's timing errors. Members with a high error rate, generally between five and ten percent, are scheduled for a routine trade practice investigation ("TPI").<sup>22</sup> As part of the routine TPI, A&I collects the member's trading records for the time period under review, and examines all trade timing errors to determine whether the errors were broker recordation errors or firm keypunch errors. After verifying the errors, if A&I finds that the member's trade timing deficiency level exceeded five percent of his or her transactions, A&I issues either a reminder or warning letter, or refers the

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<sup>22</sup> A routine TPI is a review of a member's trading activity for potential trade violations over a three- to five-day time period. See pp. 30-31 for a discussion of the Exchange's routine TPI program.

member to the Complaint Committee for possible disciplinary action. Two reminder letters and one warning letter were issued during the target period for trade timing violations.<sup>23</sup>

#### **D. Safe Storage Capability**

The Clearing Corporation captures, saves, stores and backs-up all trade data entered into the clearing system, including those trades executed electronically on the e-cbot platform. The Clearing Corporation produces and maintains five back-up tapes throughout the day on an AS 400 computer system. These five tapes, plus a PC hard drive, are taken to a Clearing Corporation employee's home each night and returned early the next business day. The Clearing Corporation also backs-up the trade information to an AS 400 server located at a disaster recovery site in Chicago with total on-line system replication 24 hours a day. A yearly historical file of the trade register data is backed-up to tape from the AS 400 computer at the beginning of the following year, and is stored in a bank safety deposit box.

Time and Sales data are stored electronically at the Exchange.<sup>24</sup> The data are initially stored on an HP Nonstop Server (Tandem) with disks in a mirrored-configuration, which provides 100% duplication of data and offers the highest reliability. Twice daily and once monthly, the Time and Sales data are backed-up to tape.<sup>25</sup> The daily tapes are kept in a fire-proof safe on-site at the Exchange. The monthly tapes are stored off-site at the Vice President-Operations' home. In addition, Time and Sales files are saved to tape at the end of each calendar

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<sup>23</sup> Investigations W0415, W0511 and W0504 can be found in Appendix 3.

<sup>24</sup> Time and Sales data include all publicly disseminated information sent to quotes vendors (e.g., Reuters, DTN, and Bloomberg). For KCBT open outcry markets, the information contains text messages, bid, ask and trade prices, previous day's volume, open interest (as of previous day's close, as reported to the clearinghouse), high/low/last message, settlements and range quotations. The information for KCBT electronic contracts includes bid price with volume, ask price with volume, trade price with volume, high/low/last message, settlement message and range quotations.

<sup>25</sup> Time and Sales is also backed-up at the Clearing Corporation.

year with two copies made; one copy is stored on-site in the fire-proof safe, and the other is stored off-site in the Vice President-Operations' home.<sup>26</sup>

Time and Sales data are also backed-up to tape nightly from the Exchange's primary administrative server. In addition, these data are backed-up once a month to tape. Similar to the tapes backed-up from the Tandem server, the daily tapes are stored on-site in the Exchange's fire-proof safe, and the monthly tapes are stored at the Vice President-Operations' home. KCBT is also developing plans for backing-up Time and Sales data to its Chicago disaster recovery server.

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

The Division found that the Exchange maintains an adequate audit trail program. A&I uses trade register and Time and Sales data in its automated surveillance system to monitor for potential trading violations and to provide evidence of any rule violations. The Exchange's audit trail program includes quarterly audit trail reviews of clearing firms and floor members to assess compliance with order ticket and trading card recordation requirements. The Exchange also routinely monitors compliance with its one-minute trade timing requirement. The Division's review of the Exchange's full- and limited-scope reviews found that clearing firms and floor members demonstrated a high level of compliance with Exchange audit trail rules. In addition, the audit trail reviews were thorough, well documented and completed in a timely manner.

However, the Division believes that the Exchange should enhance its safe storage practices to ensure that its proprietary audit trail information is properly safeguarded, and that data recovery can be performed quickly in an emergency situation. In order to protect against theft or tampering, the daily trade data tapes taken off-site each night to an employee's home

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<sup>26</sup> KCBT currently stores year-to-date Time and Sales information back to 1993.

should be encrypted or, alternatively, deposited in a secure off-site location. In addition, trade register data and Time and Sales tapes that are backed-up yearly should periodically be tested for possible degradation or loss of data. Restore procedures also should be tested periodically to ensure an expeditious and complete recovery should the tapes be needed on an emergency basis.

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

- **Encrypt the trade data back-up tapes taken off-site each night, or alternatively, deposit them in a secure off-site location; and**
- **Periodically test the historical trade data and Time and Sales back-up tapes stored off-site for degradation or data loss, and its restore procedures for expeditious and complete system recovery.**

## VI. TRADE PRACTICE SURVEILLANCE

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

**The board of trade shall monitor and enforce compliance with 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. An acceptable program should have systems that maintain all data reflecting the details of each transaction executed on the contract market. In this regard, the program should include routine electronic analysis of these data to detect potential trading violations. The program also should provide for appropriate and thorough investigation of all potential trading violations brought to the contract market's attention, including member and Commission referrals and customer complaints. In addition, the program should have the authority to discipline, suspend, or terminate the activities of members or market participants pursuant to clear and fair standards.<sup>27</sup>

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<sup>27</sup> That aspect of Core Principle 2 which relates to the disciplining of members who violate Exchange rules is discussed below in Section VII, Disciplinary Program. This section of the report addresses the Exchange's program for monitoring its markets for possible trading abuses and the investigation of any abuses identified.

## **A. Automated Surveillance System**

The TAR serves as the Exchange's automated surveillance system. The TAR identifies possible trade practice violations in pit and electronic trading by performing edit functions based on predetermined parameters designed for specific types of trading abuses.<sup>28</sup> All trades meeting the criteria for one or more parameters are flagged as exceptions on the TAR with a violation code. The codes relate to violations such as trading ahead of customer orders, accommodation trading and wash trading. The system also identifies all cross trades, which are referred to as "ring trades" at KCBT.

A&I staff reviews the TAR daily and conducts an initial inquiry into each trade coded as a possible violation. A formal investigation is opened if further information and more detailed analyses are needed to determine whether a rule violation occurred, or if a particular member has an unusually high number of exceptions on a given day or during a given month. For example, with respect to possible wash trades and accommodation trades, A&I's initial inquiry considers factors such as the price difference between the trades, the amount of time between the trades, the price movement during that time, and the number of contracts traded. When necessary, A&I also requests trading cards and order tickets and/or discusses the questionable trade(s) with the member(s) involved.

The Division randomly selected 12 days over the course of the target period to examine A&I's daily TAR reviews. The Division found that A&I adequately reviewed all coded trades, and pertinent information reflecting staff's initial analysis regarding such trades was recorded on the respective TAR.

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<sup>28</sup> As discussed earlier on pp. 23-24, the TAR also identifies possible trade timing errors.



A&I also uses an “Observer” software application provided by e-CBOT to aid in monitoring KCBT electronic trading on its platform. The Observer system allows A&I to readily access all orders entered on e-cbot for KCBT contracts. A&I can drill down to obtain detailed information on each matched trade and related orders, or to review a trader’s activity during the current session or the past seven business days. Historical order and trade data can be accessed up to 45 days through the system. A&I can also monitor the market depth.

### **B. Routine TPIs and Special Investigations**

A&I complements its daily TAR review of all members’ trading activity with routine TPIs that examine the activity of its more active members. The Exchange strives to perform one routine TPI on each active member during the calendar year. An active member is defined as one who trades at least 300 contracts over a three- to five-day period. A routine TPI is a comprehensive examination of a member’s trading activity for possible rule violations, typically over a three-to five-day period. A&I examines at least 300 trades during a routine TPI. A&I examined 22 of the 24 active traders at the Exchange during the target period.<sup>29</sup>

A&I reviews all trades of the subject member during the designated review period of a routine TPI. Staff first obtains a report from the TAR to isolate the member’s possible timing errors and trade practice violations, and requests relevant trading cards and order tickets. A&I then analyzes all of the possible timing errors and trading violations, and reviews the order tickets and trading cards for recordkeeping compliance. A&I also interviews the member under review to discuss any possible violations. If, upon completion of its TPI, A&I concludes that a reasonable basis exists for finding that a rule violation has occurred, it will issue a reminder or warning letter, or refer the matter to the Complaint Committee for consideration of charges.

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<sup>29</sup> Active traders, as defined by the Exchange, represented approximately one-quarter of the floor population.

A&I also conducts what it refers to as “Special Investigations” whenever evidence indicates that a possible violation of Exchange rules may have occurred. Special Investigations generally are initiated from observations of unusual trading activity arising from floor surveillance, daily TAR reviews, Commission or National Futures Association referrals, or member, customer, or anonymous complaints. The Exchange’s quarterly audit trail reviews are also classified as Special Investigations.<sup>30</sup>

### **C. Floor Surveillance**

A&I conducts daily floor surveillance on the open and close of wheat, and randomly during the day for a 15- to 20-minute time period.<sup>31</sup> If a market is exceptionally active or volatile, A&I staff will stay on the floor longer, typically until the activity abates. Observations made during daily floor surveillance may result in a more targeted analysis of a member’s trading activity during A&I’s TAR review and can result in the opening of an investigation. Similarly, if A&I has reason to believe that a member is engaging in prohibited trading activity, it will closely monitor the member’s trading activity while on the floor to enhance an ongoing investigation.

A&I maintains a daily floor surveillance log for each contract.<sup>32</sup> The log reflects the observer’s initials, date and time of surveillance, and any material observations. If a possible trading violation is observed, the staff member prepares a “Floor Surveillance Report” and notes

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<sup>30</sup> A&I records information relating to each routine TPI or Special Investigation on the Exchange’s investigation log. The information recorded includes the investigation number, name(s) of the member(s) under investigation, the date the investigation was opened and closed, the name of the staff member conducting the investigation, the source of the investigation, and findings. If an investigation is referred for disciplinary action, the log will reflect the actions taken and the dates of such actions. A copy of the investigation log can be found in Appendix 4.

<sup>31</sup> Both A&I staff members observe the opening and closing periods for the wheat futures contract, due to the higher trading volume.

<sup>32</sup> A copy of the floor surveillance log can be found in Appendix 5.

this on the floor surveillance log. Floor Surveillance Reports list the following information: (1) the date and time of the observation; (2) the staff member who observed the incident; (3) the member or firm observed; (4) the possible violation; (5) any prior instances of similar conduct; (6) the action taken, including summaries of any conversations between A&I staff and members related to the incident; and (7) an investigation number if the matter is examined further.

There were no instances of suspicious trading activity observed by Exchange staff during the target period, nor did Division staff observe any suspicious activity during its routine floor surveillance.

#### **D. Adequacy and Timeliness of Investigations**

During the target period, the Exchange closed 32 investigations, which included 25 routine TPIs and seven Special Investigations. Seven of the investigations, five routine TPIs and two Special Investigations, were opened prior to the target period. The Division reviewed all 32 investigations, and conducted an in-depth review of 16 investigations for adequacy and thoroughness, including nine routine TPIs and seven Special Investigations.

Each investigation was well documented. Files included a summary of the investigative steps taken (with the date each step was completed), copies of TARs and Time and Sales, profit/loss reports for the subject member's personal trades during the time period under review, spreadsheets, work papers, summaries of interviews, letters notifying the subject member of the investigation and its results, and a copy of the investigation report. In addition, investigations were completed in a timely manner. Of the 32 closed investigations, 30 were completed within four months and two were completed within six months. Three investigations that remained open at the end of the target period have since been closed. All were completed within four months of their respective opening date. Lastly, the Exchange's investigations were generally

thorough, and investigations were expanded in scope, when appropriate, to look for possible patterns of violations.<sup>33</sup>

## **E. Conclusions and Recommendations**

The Division found that the Exchange maintains an adequate trade practice surveillance program. The Exchange reviews its TAR report on a daily basis and examines all exceptions identified on the report for possible violations. The Exchange also conducts routine trade practice investigations of its more active members, examining three to five days of trading activity for those members annually. In addition, Exchange staff conducts floor surveillance periodically each day to monitor for trading violations.

The Exchange's investigations were completed in a timely manner, well documented, and, in large part, thorough. The Exchange also improved the quality of its investigations by expanding the scope of investigations to look for possible patterns of violations, particularly when the subject member has a prior disciplinary history.

The Division has no recommendations in this area.

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<sup>33</sup> The Division, however, notes two investigations, which involved possible trading ahead of customers, that it believes should have been more thoroughly investigated. In the first investigation, #W0424, the Exchange did not investigate a possible audit trail violation involving an order that appeared to be flashed to the pit incrementally, but which did not contain requisite timestamps reflecting the time each portion was flashed for execution. Based on the one timestamp present on the customer order ticket, it appears that the broker may have traded for his own account while holding the customer order. In the second investigation, #W0511, it appears that a broker may have executed two personal trades during the closing range while holding a customer "market on close," or MOC, order. Although A&I obtained the trading card from one of the opposite brokers, it did not obtain the trading card from the broker opposite his second trade in order to confirm that the broker's personal trades were done before the closing range began. A&I should have requested the additional documentation to support its conclusion that no violation occurred.

## VII. DISCIPLINARY MATTERS

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

**The board of trade shall monitor and enforce compliance with 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.**

As noted 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. Consequently, an acceptable compliance program should provide for prompt and effective disciplinary action for any violation that is found to have been committed.

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

The Complaint Committee and the Business Conduct Committee (“BCC”) serve as the Exchange’s two primary disciplinary committees. The Complaint Committee consists of ten members representing various Exchange interests who are appointed each year by the Chairman of the Exchange and approved by the Board of Directors.<sup>34</sup> The BCC consists of five members, three of whom are elected, the First Vice Chairman of the Exchange and the President of the Clearing Corporation.<sup>35</sup> The elected members serve staggered three-year terms so that each year one new member is elected to replace a departing elected member.

The Complaint Committee is a grand jury-type committee that reviews investigation reports referred by A&I to determine whether a Notice of Charges should be issued.<sup>36</sup> In this

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<sup>34</sup> KCBT Rule 247.00.

<sup>35</sup> KCBT Rule 244.00.

<sup>36</sup> KCBT Rules 1410.00 and 1414.00.

regard, the Complaint Committee must meet within ten business days of receipt of an investigation report to consider the matter.<sup>37</sup> Exchange policy requires that the Complaint Committee determine one of the following: (1) additional investigation or evidence is necessary; (2) no reasonable basis exists for finding a violation; (3) a reasonable basis exists for finding a violation, but prosecution is not warranted;<sup>38</sup> or (4) a reasonable basis exists for finding a violation and the matter should proceed for adjudication to the BCC for hearing.

If the Complaint Committee determines that formal charges should be issued, A&I staff prepares a Notice of Charges.<sup>39</sup> A Notice of Charges must include a summary of the possible violations, the rules alleged to have been violated, and the options available to the charged party. Those options include filing a written answer within ten business days either admitting or denying the charges, or filing a “nolo contendere” plea. A failure by the charged party to file a written answer within the prescribed time period will be deemed to be a not guilty plea and a hearing will be scheduled.<sup>40</sup> Upon being served with a Notice of Charges, the charged party has the right to be represented by counsel in all succeeding stages of the disciplinary proceedings.<sup>41</sup>

The Complaint Committee receives and considers all settlement offers. If the Complaint Committee accepts a settlement offer, the offer is then forwarded to the BCC for final acceptance and approval.<sup>42</sup> The BCC must consider a settlement offer within ten business days of receipt

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<sup>37</sup> KCBT Rule 1412.00.

<sup>38</sup> If the Complaint Committee finds that there was a violation but prosecution is not warranted, it generally will issue a warning letter. The Complaint Committee did not issue any warning letters during the target period. All such letters sent during the target period were issued by A&I staff.

<sup>39</sup> KCBT Rule 1414.00.

<sup>40</sup> KCBT Rule 1414.02. A nolo contendere plea is neither an admission nor denial of guilt but has the effect of a member waiving all proceedings except a hearing, if necessary, to set appropriate penalties. KCBT Rule 1414.02(f).

<sup>41</sup> KCBT Rule 1425.00(a).

<sup>42</sup> KCBT Rule 1416.00.

from the Complaint Committee.<sup>43</sup> If the BCC rejects a settlement offer, a full hearing on the matter is scheduled either before the entire BCC or a panel of the BCC.<sup>44</sup> The BCC is required, under most circumstances, to issue a written decision within 15 business days.<sup>45</sup> A decision of the BCC may be appealed to the Board within ten business days. The Board or a panel of the Board is required to hear the appeal within 20 business days and to issue a written decision within 30 calendar days of the hearing.<sup>46</sup>

## **B. Sanctions Imposed**

Three cases, involving two floor members and one clearing firm, were referred by A&I to the Complaint Committee for disciplinary action during the target period.<sup>47</sup> Each of the cases was subsequently settled. Two of the cases involved audit trail recordkeeping violations, and the third case involved a firm's accurate reporting of open positions two days before last trading day in July 2005 wheat. The Exchange levied fines of \$100, \$200, and \$500, respectively, against the three members.<sup>48</sup> Although \$800 is a small amount of fines for a 12-month period, except for the two investigations described earlier where additional inquiry should have been conducted,

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<sup>43</sup> KCBT Rule 1417.00.

<sup>44</sup> KCBT Rules 1417.01 and 1421.00. No hearings were held during the target period.

<sup>45</sup> KCBT Rule 1432.01.

<sup>46</sup> KCBT Rules 1437.00 and 1442.00.

<sup>47</sup> During the target period, A&I also issued 23 reminder letters and 12 warning letters, predominately for trade timing and recordkeeping violations.

<sup>48</sup> In all three cases, the Complaint Committee rejected the initial settlement offers. The two floor members originally offered warning letters and the clearing firm offered \$300.

the Division did not find anything to suggest that additional cases should have been brought before a disciplinary panel.<sup>49</sup>

Both recordkeeping cases resulted from a limited scope audit trail review in November 2004 of members who had recently received either a reminder letter or warning letter for audit trail violations. The member who received a \$200 fine had received a previous warning letter in September 2004. The member who was fined \$100 had received warning letters in the two previous months, September and October 2004, and reminder letters and warning letters in 2002 and 2003. Given the member's history of recordkeeping violations, the Division believes that the Exchange should have imposed a larger sanction.

### **C. Timeliness of Disciplinary Procedures**

The Division found that the Complaint Committee reviewed investigation reports promptly after receiving them. Exchange rules require that the Complaint Committee meet within ten business days of receiving an investigation report to consider the report and determine whether to issue a Notice of Charges within ten business days of the respective meeting.<sup>50</sup>

The Complaint Committee met two times during the target period to review the investigation reports for the three above-noted cases. In each instance, the Complaint Committee met within ten business days of receiving an investigation report to consider the report, reached its decision on the day of the meeting, decided to issue a Notice of Charges, and issued such notice within ten business days following the meeting. All of the respondents submitted settlement offers within 14 days, and those offers were reviewed and accepted by both the Complaint Committee and the BCC within 20 days of their submission.

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<sup>49</sup> See n. 33 at p. 33 for a discussion of the two investigations.

<sup>50</sup> KCBT Rules 1412.00 and 1413.00.



#### **D. Conclusions and Recommendation**

The Exchange's Complaint Committee considered three cases during the target period. Two cases involved audit trail recordkeeping violations by two floor members, and one involved inaccurate reporting of open interest by a member firm. The two members were fined \$100 and \$200, respectively, and the firm was fined \$500. The Exchange also issued 23 reminder letters and 12 warning letters, primarily for trading card recordkeeping and trade timing violations.

The member who received a \$200 fine had been issued one previous warning letter regarding audit trail violations, while the member who received a \$100 fine was issued consecutive warning letters in the two months prior to the sanction, in addition to a reminder and warning letter in the two previous years. In view of the latter member's history of audit trail violations, a larger sanction was warranted.

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

- **Impose sanctions that serve as an effective deterrent against members who repeatedly violate the Exchange's audit trail rules.**

## **VIII. DISPUTE RESOLUTION**

### **Core Principle 13 – Dispute Resolution:**

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

Pursuant to the acceptable practices set forth in Appendix B to Part 38, an exchange is required to provide a customer dispute resolution mechanism that is fundamentally fair and equitable, and available on a voluntary basis. In this regard, customers should have the opportunity to have their claims heard and decided by an objective and impartial decision maker. Each party should have the right to counsel and be provided with adequate notice of claims presented against him or her and an opportunity to be heard on all claims, defenses, and counterclaims. In addition, the process should provide for the opportunity of a prompt hearing, and parties should be notified of the fees and costs that may be assessed. An exchange's dispute resolution mechanism also should authorize prompt, written, final settlement awards that are not subject to appeal within the exchange. Finally, if an exchange provides procedures for the resolution of member-to-member disputes (not involving customers), the procedures for resolving such disputes must be independent of and not interfere with the resolution of customers' claims or grievances.

#### **A. Customer Arbitration**

KCBT customers are afforded voluntary dispute resolution through the Exchange's customer arbitration rules and procedures. A customer may elect to have his or her claim or grievance against a member or its employees heard by either a panel of the Exchange's Arbitration Committee or by a specially constituted panel which has at least a majority of panel

members who are not Exchange members or associated with any member of any designated contract market or employee thereof.<sup>51</sup>

Any customer desiring to submit a matter in dispute for arbitration must file a written sworn complaint alleging the nature of the dispute, the basic facts, the damages sought, and the name of the member within one year after the date of the transaction from which the dispute arose. If the member fails to answer the complaint in writing within ten days, or fails to sign an agreement to arbitrate, the member will be deemed as refusing to arbitrate and incurs the possibility of disciplinary action by the BCC, including an award for the customer.<sup>52</sup> A member also has the right to file counterclaims that arise out of the transaction or occurrence that is the subject of the customer's claim or grievance. The customer must reply to the counterclaim within ten days.<sup>53</sup>

Arbitration proceedings are held at the KCBT, unless otherwise agreed to by the parties, and are required to take place in a timely manner. Each party has the right to be represented by counsel at its own expense. Each party also is entitled to appear in person or by telephone conference at the arbitration hearing unless the claim submitted is less than \$2,500, in which case the claim may be resolved without a hearing on the basis of submitted written documents.<sup>54</sup>

The hearing body must meet to discuss the case within two business days after the hearing and make its decision within ten business days after receipt of the transcript. The hearing body must render its award(s) or finding(s) within five business days after its decision.

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<sup>51</sup> KCBT Rules 1500.00, 1503.00, 1503.01 and 1503.02. A customer also may elect to have his or her claim or grievance heard by a single arbitrator who meets the requirements of former Commission Regulation 180.2(a). KCBT Rule 1503.03.

<sup>52</sup> KCBT Rules 1510.00, 1510.01, 1514.00, and 1517.00.

<sup>53</sup> KCBT Rules 1524.00 and 1524.01.

<sup>54</sup> KCBT Rules 1528.00, 1528.01, 1528.02, 1528.03, 1529.00 and 1531.00.

There is no right to appeal to any entity within the KCBT to overturn the arbitration decision. The only right of appeal is under applicable law. A member's refusal to comply with an award within 30 calendar days of its issuance is a violation of KCBT Rules.<sup>55</sup>

Arbitration fees are initially paid by the party bringing the case. Those fees, and any additional incurred costs, are ultimately assessed against either of the parties in the case, as may be decided by the hearing body and included in its award or finding.<sup>56</sup>

KCBT considered one customer arbitration case during the target period, which the Division found was handled in accordance with Exchange rules and procedures.

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

KCBT's member-to-member arbitration rules and procedures are generally similar to the customer arbitration rules. However, any member who commences legal action against another member for any dispute must first attempt to arbitrate under Exchange rules or be subject to Exchange disciplinary action. If arbitration has been attempted and rejected, then a legal action may be commenced and the member failing or refusing to arbitrate also may be subject to Exchange disciplinary action. Exchange rules also provide that member-to-member disputes involving futures contract transactions are independent of and separate from any customer claims or grievances submitted for dispute resolution.<sup>57</sup> There were no member-to-member arbitrations during the target period.

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<sup>55</sup> KCBT Rules 1541.00 through 1541.06.

<sup>56</sup> KCBT Rules 1548.00 and 1551.00.

<sup>57</sup> KCBT Rules 1600.00, 1603.00 and 1604.00.

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

KCBT rules provide customers with voluntary procedures for arbitration that are fundamentally fair and equitable. Each party has the right to counsel and each party receives adequate notice of the claims presented against them and an opportunity to be heard on all claims, defenses, and counterclaims. KCBT's arbitration procedures require a prompt hearing and authorize prompt, written, final settlement awards that are not subject to appeal within the Exchange. KCBT also provides adequate arbitration procedures for member-to-member disputes. Any member who commences legal action against another member for any dispute must first attempt to arbitrate under Exchange rules or be subject to Exchange disciplinary action. In addition, member-to-member arbitration procedures are separate from and independent of customer claims or grievances.

The one customer arbitration case heard during the target period was handled in accordance with Exchange rules and procedures. There were no member-to-member arbitrations during the target period.

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