

**RULE ENFORCEMENT REVIEW  
OF THE CHICAGO CLIMATE  
FUTURES EXCHANGE,  
THE HEDGESTREET FUTURES  
EXCHANGE, AND  
THE U.S. FUTURES EXCHANGE**



**Division of Market Oversight**

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# **RULE ENFORCEMENT REVIEW OF THE CHICAGO CLIMATE FUTURES EXCHANGE, THE HEDGESTREET FUTURES EXCHANGE, AND THE U.S. FUTURES EXCHANGE**

## **I. INTRODUCTION**

The Division of Market Oversight (“Division”) has completed a rule enforcement review of the market surveillance, audit trail, trade practice surveillance, disciplinary, and dispute resolution programs of the Chicago Climate Futures Exchange (“CCFE”), the HedgeStreet Futures Exchange (“HedgeStreet”), and the U.S. Futures Exchange (“USFE”).<sup>1</sup> The review focuses on compliance with relevant core principles under Section 5(d) of the Commodity Exchange Act (“Act”), as amended by the Commodity Futures Modernization Act of 2000, and Part 38 of the Commission’s regulations.<sup>2</sup> It covers a 21-month target period, from April 1, 2005 to December 31, 2006,<sup>3</sup> during which all three exchanges received similar regulatory services from NFA.

In this review, the Division departed from its usual practice of issuing one report per exchange. As explained below, NFA provides its regulatory services via separate agreements with CCFE, HedgeStreet, and USFE. For all three exchanges, however, NFA uses similar systems, methods, and personnel. Accordingly, the Division combined what would otherwise be

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<sup>1</sup> When the Division began its review, USFE was under different ownership and was commonly known as Eurex US. Throughout the review period and up to the present, however, the designated contract market (“DCM”) was and remains U.S. Futures Exchange. The analysis and recommendations made herein apply to USFE. Further details on the Exchange’s transition from Eurex US to USFE are provided below.

<sup>2</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 is not designed to uncover all instances in which an exchange does not effectively address all exchange rule violations or other deficiencies. Neither is such 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>3</sup> The original target period for all three exchanges was April 1, 2005 to March 31, 2006. It was subsequently expanded through December 31, 2006 to incorporate a larger number of inquiries, investigations, and other substantive compliance work by the exchanges and the National Futures Association (“NFA”).

three separate reports into a single document to avoid unnecessary repetition. Although the review examined NFA's services in detail, it is an evaluation only of the exchanges' fulfillment of their self-regulatory responsibilities under the relevant core principles.

For purposes of this review, the Division examined the exchanges' compliance with seven core principles. The core principles under review included two relating to market surveillance: Core Principle 4, *Monitoring of Trading*, which relates to an exchange's program to prevent manipulation, price distortion, and disruptions of the delivery or cash settlement process; and Core Principle 5, *Position Limitations or Accountability*, which relates to an exchange's program for enforcing its speculative position limits and position accountability rules.

The Division also reviewed certain core principles relating to the audit trail, trade practice surveillance, and the disciplinary process. These included: Core Principles 10, *Trade Information*, and 17, *Recordkeeping*, which relate to an exchange's audit trail program for the recording and safe storage of trade information in a manner which enables prevention of customer and market abuses and enforcement of exchange rules; and Core Principles 2, *Compliance With Rules*, and 12, *Protection of Market Participants*, which relate to an exchange's program for enforcing its rules, conducting disciplinary proceedings, and protecting market participants from abusive practices.

Finally, the Division reviewed the three exchanges' compliance with Core Principle 13, *Dispute Resolution*, which relates to an exchange's alternative dispute resolution program for market participants. Appendix B to Part 38 provides acceptable practices for demonstrating compliance with some these core principles.<sup>4</sup>

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<sup>4</sup> Appendix B to Part 38 of the Commission's regulations provides guidance concerning the core principles with which a DCM must comply to maintain its designation. In addition, Appendix B provides acceptable practices for several of the core principles. Although the acceptable practices offer non-exclusive safe harbors for core principle compliance, they are not the mandatory. Appendix B provides acceptable practices for Core Principles 2, 4, 5 10,

For purposes of this review, Division staff interviewed officials and staff from each of the exchanges' compliance departments and staff of NFA.<sup>5</sup> The Division also reviewed numerous documents used by the exchanges and NFA in carrying out each exchange's self-regulatory responsibilities. These documents included, among other things, the following:

- computer reports generated by NFA's automated surveillance systems and other documents used in market and trade practice surveillance;
- files and records concerning monitoring of contract expirations and position accountability enforcement;
- NFA's inquiry and investigation logs;
- exchange and NFA files and records concerning market surveillance and trade practice inquiries and investigations closed or conducted during the target period;
- NFA's written guidelines for trade practice and market surveillance;
- provisions of the Regulatory Services Agreements between the three exchanges and NFA which describe the scope of the self-regulatory services performed for each exchange by NFA; and
- minutes of exchange disciplinary committee meetings, board of directors meetings, and regulatory oversight committee meetings.

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13, and 17. Acceptable practices are not set forth for Core Principle 12. However, in promulgating Part 38, the Commission reserved the authority to adopt acceptable practices for Core Principle 12 at a later date.

<sup>5</sup> Division staff interviewed each exchange individually, with NFA representatives also present. In addition, staff conducted a separate interview with NFA. The interviews were conducted on June 14, 2006 (NFA and USFE), June 15, 2006 (CCFE), and June 23, 2006 (HedgeStreet).

## II. SUMMARY OF FINDINGS AND RECOMMENDATIONS<sup>6</sup>

### A. Market Surveillance Program

#### Findings

- CCFE, HedgeStreet, and USFE maintain adequate market surveillance programs. All three exchanges monitor futures and cash market prices, volume, open interest, and market news on a daily basis. In addition, the exchanges review trading during their daily openings and closings, and they heighten their surveillance during contract expirations.
- CCFE, HedgeStreet, and USFE conduct daily reviews of position accountability exception reports. The exchanges also have adequate procedures for reviewing clearing member and large trader positions.
- NFA conducts market surveillance for CCFE, HedgeStreet, and USFE through its Trade Analysis and Profiling System. This system generates automated alerts and offers flexible analysis tools. NFA also uses third-party vendors for real-time news, historical prices, and examining spread relationships.
- There were no problematic expirations during the target period.

#### **Recommendations**

- **The Division has no recommendations in the market surveillance area.**

### B. Audit Trail Program

#### Findings

- CCFE, HedgeStreet, and USFE maintain adequate audit trail and recordkeeping programs. The three exchanges' audit trails include complete electronic records of all entries into their trading engines and the details of every trade, allowing them to reconstruct trading efficiently and effectively.

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<sup>6</sup> While the findings below are stated in terms of CCFE, HedgeStreet, and USFE, much of the exchanges' daily regulatory work is performed by NFA. However, as DCMs, the three exchanges remain responsible for core principle compliance and the execution of their self-regulatory obligations. All recommendations made in this rule enforcement review apply only to the relevant exchange(s). In this regard, the Division notes that Section 5c(b)(1) of the Act permits exchanges to "comply with any applicable core principle through delegation of any relevant function to a registered futures association or another registered entity." However, Section 5c(b)(2) specifies that any exchange that delegates a function "shall remain responsible for carrying out the function." In addition, under Section 5c(b)(3), if an exchange "becomes aware that a delegated function is not being performed as required...[it] shall promptly take steps to address the noncompliance."

- The exchanges' audit trails are integrated into NFA's surveillance systems, allowing NFA to monitor for potential trading violations, conduct inquiries, and gather evidence of potential violations.
- CCFE, HedgeStreet, and USFE all have adequate procedures in place for safe storage of audit trail data. Data is stored at exchange and NFA on-site and off-site locations.

### **Recommendations**

- **The Division has no recommendations in the audit trail area.**

## **C. Trade Practice Surveillance Program**

### **Findings**

- CCFE, HedgeStreet, and USFE maintain adequate trade practice surveillance programs. NFA uses automated exception reports and tools to identify potential trading violations and conduct initial inquiries.
- CCFE, HedgeStreet, and USFE coordinate with NFA when potential rule violations are identified. NFA conducts inquiries for all three exchanges and works with them to complete investigations where appropriate.
- All inquiries and investigations during the target period were completed in a timely manner. Investigations were well documented and thorough, and matters under review were expanded when appropriate.
- One HedgeStreet investigation during the target period was resolved through a reminder letter sent to two members. The two members admitted to pre-arranging trades to pass money from one member's account to the account of the other. The Division believes that a reminder letter was an inadequate sanction in this matter.

### **Recommendations**

- **HedgeStreet should submit substantive trade practice violations, including where money is passed between members' accounts via pre-arranged trading, to formal disciplinary proceedings and should sanction such violations in a meaningful manner.**

## **D. Disciplinary Program**

### **Findings**

- CCFE, HedgeStreet, and USFE have the requisite authority to investigate potential rule violations, prosecute cases, and discipline members and market participants.



- The exchanges' rules provide that respondents shall have the right to counsel and have a sufficient opportunity to present their defense, call witnesses, and offer evidence.
- Neither CCFE nor HedgeStreet brought disciplinary cases during the target period. Accordingly, the Division has no basis upon which to evaluate the adequacy of these exchanges' disciplinary programs.
- USFE levied monetary sanctions in three cases during the target period. In a case involving improper execution and reporting of an EFP, the Exchange levied a \$3,000 fine. In two cases involving a USFE incentive program, the Exchange levied fines of \$30,000 and \$75,000 against two member firms.
- When USFE first became aware of questionable trading related to the incentive program, it promptly notified Division staff. NFA began an investigation and the Exchange issued a regulatory bulletin reminding members of appropriate trading practices.
- The sanctions levied in all three USFE cases were adequate. However, in the incentive program cases, USFE's Disciplinary Committee may not have fully understood what constitutes wash trading and the relevant factors to be considered in a wash trading analysis.
- The minutes for both USFE incentive program cases failed to demonstrate that the Disciplinary Committee considered and deliberated with respect to all the rule violations alleged by NFA. The minutes also failed to demonstrate that the Disciplinary Committee considered issuing charges against all of the parties recommended by NFA.
- In one of the USFE incentive program cases, NFA did not recommend charges against the firm's traders because the traders were independent contractors, and, as such, neither NFA nor USFE believed that the Exchange's rules provided for jurisdiction.

## **Recommendations**

- **USFE should ensure that its Disciplinary Committee members understand what constitutes wash trading, as defined by the Commission, and the relevant factors to be considered in a wash trading analysis.**
- **USFE should ensure that Disciplinary Committee minutes demonstrate that the committee deliberated regarding all rule violations alleged by NFA against all parties.**
- **USFE should amend its Rulebook so that it may exercise jurisdiction over persons associated with members, whether such persons are associated with a member as an employee or independent contractor.**

## **E. Dispute Resolution Program**

### **Findings**

- CCFE and USFE rules provide fair and equitable procedures for the resolution of customer disputes. Customer arbitration is not relevant to HedgeStreet because its markets are not intermediated.
- CCFE and HedgeStreet provide fair and equitable procedures for the resolution of disputes between members. Member arbitration is not mandatory at USFE and is not provided for in its rulebook. Members, however, are free to arbitrate any disputes that arise between them.
- The three exchanges' dispute resolution procedures are based on NFA's Code of Arbitration, which is incorporated in their respective rules by reference.
- There were no arbitrations at any of the exchanges during the target period.

### **Recommendations**

- **Because none of the exchanges had an arbitration during the target period, the Division has no basis upon which to evaluate the adequacy of their dispute resolution programs.**

## **III. OVERVIEW OF EXCHANGES AND THEIR COMPLIANCE STAFFS**

### **A. Chicago Climate Futures Exchange**

CCFE was approved by the Commission as a DCM on November 9, 2004, and began trading on December 10, 2004. The exchange was formed to offer standardized futures contracts on emission allowances and other environmental products. The Exchange is a wholly owned subsidiary of the Chicago Climate Exchange, and its corporate offices are located in Chicago, Illinois.<sup>7</sup> CCFE offered one contract during the target period—futures on sulfur dioxide emission allowances. All trading on CCFE is electronic, and clearing services are provided by The Clearing Corporation.

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<sup>7</sup> The Chicago Climate Exchange is an Exempt Commercial Market under Part 36 of the Commission's regulations.

During the 21-month target period, 34,540 contracts were traded on CCFE. Since then, volume has increased materially, to 182,598 contracts traded in the nine-month period from January 1, 2007 through September 30, 2007. The majority of the trading volume on the Exchange is generated by utilities that are subject to the Environmental Protection Agency's Acid Rain Program. As of the end of the target period, CCFE had approximately 88 "Trading Privilege Holders" ("TPHs"). TPHs are any person or entity holding trading privileges on the Exchange. They are deemed to be members of the Exchange and must be of good financial standing and meet financial and other reporting requirements. Trading privileges are nontransferable and non-assignable. TPHs have the right to access the CCFE trading platform, including the right to place orders for proprietary accounts and on behalf of customers.<sup>8</sup> Each TPH may permit one or more individuals to act as its "authorized traders," subject to Exchange requirements.<sup>9</sup>

## **B. HedgeStreet Futures Exchange**

HedgeStreet was approved as a DCM on February 18, 2004, and began trading on October 1, 2004. During the target period, it was owned and operated by HedgeStreet, Inc., a privately held corporation based in San Mateo, California.<sup>10</sup> HedgeStreet offered electronic trading of

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<sup>8</sup> CCFE Rule 302.

<sup>9</sup> CCFE Rules 303 and 304.

<sup>10</sup> On September 28, 2007, HedgeStreet temporarily suspended the listing of any contracts and ceased listing any contract that had an expiration date beyond September 28, 2007. In addition, on October 1, 2007, HedgeStreet commenced the return of all customer segregated funds. On November 15, 2007, HedgeStreet signed an agreement and plan of merger with IG Group Holdings plc ("IG"). IG purchased all of HedgeStreet's shares. Due to the change of ownership, on February 6, 2008, HedgeStreet filed a Rule 38.5(d) notification with the Commission certifying that HedgeStreet meets all of the requirements of Sections 5(b) and 5(d) of the Act and the provisions of Part 38 of the Commission's regulations, including all designation criteria and core principles. HedgeStreet resumed listing contracts and trading on February 11, 2008.

futures contracts in binary options and capped futures products.<sup>11</sup> HedgeStreet's contracts included foreign currency, gold, and oil price contracts, as well as contracts on the outcome of specific macroeconomic events, such as the monthly non-farm payroll report. During the target period, 1,425,034 contracts were traded on the Exchange. A further 121,256 contracts were traded in the period January 1 through September 30, 2007.

Under HedgeStreet rules, orders may be entered into the trading engine only by Exchange members, who must be natural persons residing in the United States or entities organized in the United States. An entity applying for membership must designate at least one natural person who is authorized to trade in its account. In order to become a member, applicants must complete and submit the HedgeStreet membership on-line application form, and provide the Exchange with any other information it may request. Natural persons trading on the Exchange for their own account or for a member may not maintain or trade more than one account.<sup>12</sup> As of the end of the target period, the Exchange had 1,546 members.

During the target period, HedgeStreet operated only as a non-intermediated market. Every Exchange member—whether a natural person or a business entity—was the beneficial owner of trading in their account. Exchange members are required to have on deposit sufficient funds to cover the full potential payout of their trades. Any orders not backed by sufficient funds will not be executed.

### **C. United States Futures Exchange**

USFE was approved by the Commission as a DCM on February 4, 2004, and began trading on February 8, 2004. On October 1, 2006, USFE came under new ownership after Man

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<sup>11</sup> Capped products are futures or options whose maximum payoff at contract expiration is limited based on maximum and minimum values of the underlying economic product.

<sup>12</sup> HedgeStreet Rule 3.1.

Group plc purchased a nearly 70 percent stake in the former Eurex US. During the target period, the Exchange offered electronic trading of futures contracts in U.S. dollar-denominated fixed-income derivatives (futures and options on 2-, 5- and 10-year U.S. Treasury Notes, 30-year U.S. Treasury Bonds, and Russell index contracts).<sup>13</sup> USFE trades are cleared and guaranteed through The Clearing Corporation. During the target period, a total of 1,100,656 contracts were traded on the Exchange. Since then, volume has fallen to only 157 contracts for the period January 1 to September 30, 2007.

During the target period, most of USFE's members were institutional participants, including global financial institutions and banks, securities firms, futures commission merchants, and proprietary trading firms. USFE averaged 163 members during the target period. Natural persons and legal entities are both eligible to become Exchange members, provided that they meet certain financial and other requirements.<sup>14</sup> Entities applying for membership must designate a natural person authorized to represent it and at least one person who will be an authorized trader. Entities must detail their directors, officers, partners, or others who will control it.

#### **D. Compliance Staffs**

Market surveillance and trade practice surveillance for the three exchanges are conducted primarily by six NFA Trade Practice and Market Surveillance ("TPMS") staff members. The TPMS staff members include the Director of Trade Practice/Market Surveillance; the Senior Manager for Market Services/Technology; a Manager for Trade Practice/Market Surveillance; a

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<sup>13</sup> Contracts currently offered by USFE include equity index derivatives, binary options, FX spot equivalent futures, and wind power contracts.

<sup>14</sup> USFE Rule 302.

Senior Analyst; an Analyst; and a Compliance Coordinator.<sup>15</sup> TPMS also includes an Administrative Assistant. The Manager and the Senior Manager report to the Director of Trade Practice/Market Surveillance.

In addition to the TPMS personnel described above, NFA has other staff resources that it may call upon, if necessary. For example, NFA implemented a cross-training program that prepared six additional staff members, who are normally assigned elsewhere within NFA, to assist with trade practice and market surveillance. These additional staff members are available to help with compliance services should future increases in trading volume warrant additional staff. In addition, TPMS may call upon in-house technology resources and personnel whenever new or special needs arise with respect to NFA's automated surveillance infrastructure.

Although the services provided by NFA to the three exchanges under review are broadly similar, certain differences exist. NFA's services for CCFE include trade practice and market surveillance, investigation and prosecution of disciplinary matters, and auditing and financial surveillance. NFA has the independent authority to initiate and conduct investigations at CCFE, but always informs the CCFE's compliance staff of pending investigative matters.

The regulatory services provided by NFA for HedgeStreet include trade practice and market surveillance, as well as auditing and financial surveillance. Responsibility for formal investigations and disciplinary proceedings, however, remains with HedgeStreet. More specifically, NFA conducts initial inquiries of suspected rule violations and refers appropriate cases to HedgeStreet for further action. The Exchange provides written notification to NFA upon final disposition of any matter referred to it.

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<sup>15</sup> The Director of TPMS has more than 11 years of regulatory experience in compliance and market surveillance; the Senior Manager for Market Services/Technology has more than 21 years of regulatory experience in compliance and market surveillance; and the Manager for Trade Practice/Market Surveillance has more than 10 years of regulatory experience in compliance and market surveillance, and 15 years of experience in futures trading.

NFA's services for USFE include trade practice and market surveillance, as well as auditing and financial surveillance. NFA refers possible investigation and prosecution of disciplinary matters to USFE for resolution, although the Exchange may elect to have NFA conduct any or all of any subsequent investigation.

CCFE, HedgeStreet, and USFE also employ their own compliance staffs to perform functions not delegated to NFA, to interact with NFA, and to maintain overall responsibility for the exchanges' respective self-regulatory responsibilities. During the target period, at CCFE, the Compliance Department consisted of the General Counsel and Senior Vice-President; the Senior Vice-President of Exchange Operations; the Vice-President and Director of Compliance; the Vice-President of Information; and a Compliance Specialist. The Director of Compliance is responsible for working with NFA on compliance matters. During the target period, HedgeStreet's Compliance Department consisted of the Vice-President—Legal & Compliance and a Compliance Associate. USFE's Compliance Department consisted of the Chief of Compliance and the Head of Market Supervision, along with five additional market supervision employees.

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

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

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

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

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

Pursuant to the acceptable practices set forth in Appendix B to Part 38 of the Commission's regulations, an acceptable market surveillance program should provide for the regular collection and evaluation of 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 problems that may arise from excessively large speculative positions, an exchange may need to establish speculative limits for some commodities. Rules establishing such limits may provide for hedge or other exemptions, and the limits may be set differently for each contract, delivery month, or period when in effect. Spot month limits should be adopted for markets based on commodities having limited deliverable supplies or where necessary to minimize a market's susceptibility to manipulation or price distortion.

Position limits may not be necessary for markets where the threat of excessive speculation or manipulation is very low. For such contracts, such as financial instruments, an exchange may provide for position accountability in lieu of position limits. An exchange should have an automated large trader reporting system that is used daily to enforce compliance with position limit rules.

**A. Routine Surveillance and Surveillance of Expiring Contracts**

NFA conducts market surveillance for CCFE, HedgeStreet, and USFE. Its surveillance functions are designed to detect potential manipulations and price distortions and to ensure the orderly liquidation of expiring contracts. To this end, NFA conducts daily monitoring of prices, volume, open interest, clearing member and large trader positions, exchange openings and closings, and market news for all contracts traded on all three exchanges. TPMS staff use



several on-line quotation and information systems; automated surveillance and computer-generated reports; and real-time monitoring to facilitate their work.

NFA also conducts daily monitoring of the basis relationship between each exchange's contracts and the corresponding cash markets. For example, during the target period, HedgeStreet offered binary options in such commodities as crude oil, gold and Japanese yen, whose underlying prices can be tracked against both the futures traded on other exchanges and the cash markets. Finally, NFA periodically monitors prices and trading, on a real-time basis, during the trading session, on the open and close of trading, during contract expirations, and when important market news is due for release. This real-time monitoring is accomplished through read-only "market supervision" screens located at NFA's Chicago headquarters.

Staff of each of the exchanges can also be involved in daily market surveillance activities. For example, at CCFE, the Senior Vice-President of Exchange Operations reviews the more active contract months to identify market participants and monitors the order pricing trends for the day (which is important in determining mid-day and settlement prices).

### **1. NFA's Trade Analysis and Profiling System**

The principal technology tool used by NFA to conduct market surveillance is an alert and analysis program called the Trade Analysis and Profiling System ("TAPS").<sup>16</sup> TAPS was developed internally by NFA and features a variety of automated alerts and flexible analysis tools within one integrated system. Automated alerts are generated when predefined trading parameters, which can be altered if needed, are breached. Each alert signals NFA staff to review potentially violative activity at CCFE, HedgeStreet, or USFE. Staff's review of alerts is aided by a suite of highly flexible TAPS tools that permit detailed analysis of trades, traders, and trading

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<sup>16</sup> As described in Section VI, below, TAPS is also the primary technology tool used for trade practice surveillance.

patterns and relationships. TAPS also includes a “notes” function that allows NFA staff and supervisors to document and track their surveillance work on-line.

TAPS gives NFA staff access to the exchanges’ historical price records and generates alerts whenever upward or downward price moves exceed pre-set parameters. In addition, NFA uses third-party vendors, including Bloomberg and Commodity Quotes Graphics, for real-time news and cash market prices. The services provided by these vendors enable NFA to chart historical price and spread relationships for the exchanges’ contracts. These services also enable NFA to chart changing price relationships between contracts at CCFE, HedgeStreet, and USFE versus those at other exchanges whose contracts involve similar underlying products.

NFA monitors volume and open interest at each exchange on a daily basis. NFA reviews the previous day’s trading volume and open interest in each contract through multiple tools available on TAPS. For example, TAPS provides a daily recap of the previous day’s trading, and enables staff to sort volume and open interest data by contract, trade type, clearing member, large trader or other market participant data. As noted above, historical volume data are also available through TAPS. TAPS sends a “management alert” to staff if any trader has a percentage of either volume or open interest beyond pre-set parameters. TAPS also maintains an electronic record of which NFA staff member reviewed each alert, and what action, if any, was taken in response. Finally, TAPS enables NFA to view trade and volume information by clearing member or by firm, and to rank positions in each contract by size.

## **2. Surveillance of Expiring Contracts**

For all three exchanges, NFA heightens its surveillance as contracts approach their expiration dates. The intensity of the surveillance performed for an expiring contract varies depending on the susceptibility of the contract to manipulation. For all contracts, NFA uses TAPS to gather a range of information relevant to every expiration. For example, in the month

prior to expiration, NFA uses TAPS' "large trader" functions to determine the volume and open interest held by significant market participants. Having identified the large position holders, NFA then tracks them on a daily basis as expiration approaches. Current position numbers are measured against historical patterns maintained in TAPS' "trader profiles" module, and any anomalies in the unwinding of positions can quickly become apparent.

TAPS also produces exception reports that are especially relevant to monitoring expiring contracts. One report, for example, alerts NFA whenever basis relationships do not narrow as expected with the approach of an expiration date. As noted previously, NFA also heightens its real-time surveillance during contract expirations. Finally, NFA can contact individual traders as contracts approach expiration to better understand the traders' intentions and strategies.

As with other surveillance performed by NFA, detailed electronic notes are maintained to document the work process.

As noted above, some contracts require heightened surveillance as their expirations approach. USFE's physically-settled interest rate futures products are one example. To surveil these contracts, NFA and USFE jointly developed special "delivery checklists," which are akin to expiration summary files. As part of the checklist, NFA begins compiling additional information starting ten days before a contract's expiration. Delivery checklists include overall open interest data by contract and open interest by commodity, firm, and month. The checklists also include large trader positions by reportable accounts, relevant news updates, and any notes on conversations with market participants to determine their intentions as expiration approaches.

Although NFA carefully monitors all contracts as they approached expiration, it does not maintain detailed checklists or expiration summary files for all contracts traded. For example, in the case of HedgeStreet and CCFE, the nature of the contracts traded and their methods of

settlement present a very low risk of problematic expirations. In addition, the compliance staffs at the two exchanges perform their own surveillance work in conjunction with NFA. Most importantly, the volume of trading at all three exchanges throughout the target period was so low that expirations and individual traders could be followed easily, and manipulative schemes were not a credible threat.

During the target period, all HedgeStreet contracts were financially settled, thus reducing the risk of problematic expirations on the HedgeStreet market. In addition, traders on HedgeStreet are permitted to control only one account, making aggregation unnecessary and the tracking of individual positions as contracts neared expiration easier. In the case of the CCFE emission allowance futures, delivery was performed via the transfer of emission allowances through the Environmental Protection Agency.

The Division notes that, during the target period, there were no problematic contract expirations identified by CCFE, HedgeStreet, or USFE.

## **B. Large Trader Reporting System, Speculative Position Limits, and Position Accountability**

### **1. Large Trader Reporting**

Large trader reporting is an integral part of a market surveillance program. It includes daily reports from reporting firms for all customers with positions at or above the applicable reporting levels. Reporting levels vary according to the size of the relevant market. Through large trader reporting, exchanges can identify potential problems in a market before they occur. Large trader reports allow exchange and CFTC staff to identify the largest long and short positions in a market. Such information is particularly relevant as contracts approach the

delivery or spot month and surveillance must be conducted for concentration of positions, orderly liquidations, and any indications of manipulation.

Large trader reporting for each of the three exchanges is an integrated function of TAPS, whose pre-set alerts inform NFA whenever a trader reaches large trader status.<sup>17</sup> When a reportable level threshold for a particular contract is reached at any of the three exchanges, NFA obtains a CFTC Form 102 from the trader and enters the information into the TAPS list of large traders.<sup>18</sup> TAPS' large trader function generates large trader reports that are reviewed daily by NFA staff. TAPS aggregates all positions held by related parties, which generally means all positions in accounts under direct or indirect common control.<sup>19</sup> Once this information is compiled, NFA monitors large trader positions for concentrations of ownership and potential collusive or concerted activity by market participants. If it appears that the position of any one trader or account controller constitutes a significant proportion of open interest in a contract, NFA procedures call for NFA to contact the trader or controller to determine the reason for the concentration.

TAPS also enables NFA staff to view complete information regarding each large trader's trading history at any time. As with other reports, TAPS maintains an electronic record

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<sup>17</sup> The reportable levels for USFE products, established pursuant to Commission Regulation 15.03, are: 2,000 futures contracts on 5-Year U.S. Treasury Notes; 2,000 futures contracts on 10-Year U.S. Treasury Notes; and 1,500 futures contracts on 30-Year U.S. Treasury Bonds. CCFE reportable levels are 25 contracts in each of its futures and options contracts. HedgeStreet reportable levels are 12,500 contracts for each of its currency products; 1,750 contracts for its gold and crude oil products; and 1,400 contracts for its silver products. The minimum reportable levels are set pursuant to a no-action letter issued by the Division on March 22, 2006 (CFTC letter No. 06-07). The letter establishes that positions with a maximum return of \$1,250,000 should be reportable. Thus, 12,500 of \$100 currency instruments would have a maximum value of \$1,250,000. HedgeStreet may set more stringent reporting requirements depending on the liquidity of the underlying instruments, as seen in the reportable levels for the physical commodity products traded on the Exchange.

<sup>18</sup> CFTC Form 102 contains account ownership and control information. In the case of HedgeStreet, the Exchange is responsible for providing a Form 102 to NFA and the CFTC because there are no Exchange clearing members. HedgeStreet did not file any Form 102s during the target period.

<sup>19</sup> "Related parties" is defined in each exchange's rulebook (USFE Rule 4.12(c), CCFE Rule 4.09(e), and HedgeStreet Rule 5.13(e)).

of each large trader report reviewed, including a record of staff notes concerning any action that was taken. At the beginning of the target period, NFA also maintained daily large trader data in an Excel spreadsheet, through which it tracked day-to-day changes in large trader positions. That process has now been automated through the new Large Trader Trend Analysis tool.

## **2. Speculative Position Limits, Position Accountability, and Hedge Exemptions**

Position accountability and speculative position limit practices vary at each of the three exchanges under review. At USFE, all contracts traded during the target period were subject to position accountability threshold levels, but none were subject to speculative position limits. HedgeStreet applied speculative position limits to contracts with an underlying physical commodity (*e.g.*, crude oil binary options, gold binary options, natural gas binary options, *etc.*), but did not apply position accountability levels on any of its contracts. Finally, like HedgeStreet, CCFE had speculative position limits, but no position accountability. CCFE's speculative limits applied to the nearby month of its SFI futures contract, the only contract offered during the target period. Due to low trading volumes, no market participant at HedgeStreet or CCFE came near the exchanges' speculative position limits.

Notwithstanding whether an exchange has speculative position limits or position accountability provisions, NFA monitors compliance through TAPS' large trader function. The large trader data monitored each day by NFA include the position accountability and speculative position limit data applicable to each trader's positions. TAPS has exception reports which alert NFA whenever a trader reaches or exceeds a relevant threshold. During the target period, enforcement of position accountability and speculative position limits was a collaborative effort between NFA and each of the exchanges under review, with NFA serving in a "front-line" capacity. With its TAPS resources, automated alerts, and access to large trader

and other data, NFA could identify potential threshold violations and notify the relevant exchange for further action.

In the case of USFE and its position accountability levels, NFA notifies the Exchange's Compliance Department whenever a USFE member reaches or exceeds a position accountability threshold. The USFE Compliance Department then contacts the relevant member, via telephone or e-mail, with a request for information on the nature of the position, the trading strategy involved, and the member's financial ability to maintain the position. After receiving the requested information, the Compliance Department determines whether the Exchange needs to impose any conditions with respect to the size of the trader's position. If conditions are imposed, USFE then notifies NFA which monitors the trader's future position sizes to ensure ongoing compliance with the conditions. During the target period, one USFE member reached a position accountability level. The position was reported to USFE who handled it in the routine manner described above.

HedgeStreet and CCFE had speculative position limits in certain contracts during the target period. Trading volumes at both exchanges were very low throughout the target period, and at no time were speculative position limits reached. Had speculative position limits been breached, the positions would have been detected by TAPS. NFA then would have alerted the relevant exchange's compliance department, which would then have decided whether to pursue the matter independently or with NFA's assistance. In the case of HedgeStreet, its Compliance Department had sufficient data at its disposal that it also could have identified any members nearing the speculative position limits, independently of NFA. This reflects the fact that traders on HedgeStreet are permitted to control only one account, making aggregation unnecessary. As

noted previously, neither HedgeStreet nor CCFE had position accountability levels during the target period.

Finally, of the three exchanges, only CCFE permitted hedge exemptions. However, as no CCFE member reached the Exchange's speculative position limits, the hedge exemption process was never invoked.

## **C. Exchange of Futures for Physicals**

### **1. United States Futures Exchange**

During the target period, 164,382 USFE contracts were traded as “exchange of futures for physicals” (“EFP”) transactions. EFPs are governed by USFE Rule 416, which imposes certain conditions upon EFP transactions. Among other things, the commodity being exchanged must have a high degree of price correlation with the underlying commodity of the futures contract, such that the futures contract would serve as an appropriate hedge for the commodity. In addition, the quantity of the commodity being exchanged must correspond with the quantity of the underlying commodity in the futures contract. A third EFP requirement is that the purchase and sale of the commodity must be simultaneous with the sale and purchase of the futures contract. Finally, although the parties to an EFP transaction are free to arrive at a mutually satisfactory price, such price must be within a specified range of the day’s high and low prices. The acceptable range varies by contract and includes both prices below the day’s low and prices above the day’s high.

Upon request by the Exchange, members must “produce satisfactory evidence that the EFP...was arranged in accordance with the Rules...”<sup>20</sup> Items which the Exchange may request

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<sup>20</sup> USFE Rule 416.



include “full documentation relating to the cash leg of the EFP.”<sup>21</sup> EFP activity at USFE is reviewed by NFA daily. Daily reviews consist of reviewing pricing on the futures leg of the EFP transaction to ensure that it is within the permitted range, as described above. In addition, NFA conducts more detailed monthly reviews of a random selection of EFP transactions. In these reviews, NFA requests all relevant documentation, including trade records, bank records, account statements, and cash statements to verify the movement of funds and the transfer of the underlying commodity. NFA also analyzes the trades to confirm that there was a high degree of correlation between the underlying commodity and the futures contract.

As a result of the surveillance effort outlined above, USFE issued four warning letters during the target period for improperly documented EFP transactions. In addition, one EFP transaction during the target period resulted in a \$3,000 fine against a USFE clearing member firm. The underlying violation stemmed from the firm’s failure to report the transaction within 60 minutes of execution, as required by Exchange rules.

## **2. Chicago Climate Futures Exchange**

CCFE permits exchange of futures for physicals (“EFP”) transactions. Under CCFE’s rules, EFPs must involve related futures and cash transactions; an exchange of futures for the underlying commodity with transfer of ownership of the commodity; and separate persons with accounts having different beneficial ownership or under separate control.<sup>22</sup> Prior to executing an EFP, the parties to the transaction must submit it to the Exchange for approval. EFPs must be priced within the daily price limit, and, if executed during the trading session, they must be reported within 30 minutes of execution. Exchange rules also state that EFPs executed after trading hours must be reported within 15 minutes after the opening of the next trading session.

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<sup>21</sup> Id.

<sup>22</sup> CCFE Rule 411.

There were no EFPs at CCFE during the target period. However, had there been any EFPs, they would have been reviewed by NFA in its daily review of trading activity. Other off-centralized-market transactions, such as exchanges of futures for swaps and exchanges of futures for risk, were not permitted at CCFE during the target period.

### **3. HedgeStreet Futures Exchange**

HedgeStreet did not permit EFPs or other off-exchange transactions during the target period.

#### **D. Conclusions**

The Division found that USFE, CCFE, and HedgeStreet all maintain adequate market surveillance programs. NFA is sufficiently staffed and experienced to perform effective market surveillance on behalf of the exchanges. In addition, all three exchanges have sufficient staff to interact with NFA as it conducts market surveillance on their behalf.

NFA conducts daily monitoring of futures and cash market prices, market news, volume, open interest, and clearing member and large trader positions relating to each exchange contract. NFA also heightens surveillance as contracts near expiration. There were no problematic contract expirations at any of the exchanges during the target period. In addition, NFA conducts daily review of position accountability and reviews trading information to identify unusual or abnormal price relationships. NFA's automated computer systems, including its large trader reporting function and trader profile function in TAPS, make relevant data and exception reports available to and sortable by NFA analysts. These systems give NFA and each exchange routine access to the positions and trading of market participants. Finally, NFA has procedures to review EFP transactions and conducted adequate surveillance at USFE, the only exchange to see EFPs during the target period.

Based on the foregoing, the Division has no recommendations with respect to HedgeStreet's, CCFE's or USFE's market surveillance practices.

## 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 five years.**

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

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.

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

### **1. Chicago Climate Futures Exchange**

All CCFE trades are processed through the CCFE Trading System (“Trading System”). Market participants communicate and place orders with the Trading System over the internet through a web-based interface. The Trading System executes trades in accordance with an algorithm that gives first priority to orders based on best price, and then gives priority among orders at the same price on the basis of time of entry into the Trading System. Clearing members guarantee the activity of the traders whose trades they clear.

Under CCFE rules, orders may be entered into the Trading System only by Exchange members, by authorized employees of members or of members’ affiliates (“authorized traders”), or through a member’s automated order routing system. CCFE assigns a unique identification code—the member ID—to each Exchange member. In addition, Exchange rules require each

member to assign a separate identification code—the trader ID—to each authorized trader employed by it or its affiliates. To access the Trading System and place orders, authorized traders must provide both their member and trader IDs. All orders placed on the Trading System identify both the member and the authorized trader.

The Trading System will not accept orders unless they include all order information required under Exchange rules. In addition to member and trader IDs, the required information includes the following: buy/sell indicator; contract; delivery month; price; order type; quantity; time or period after which the order expires; account number or identifier; customer type indicator; and origin code showing whether the order is for a customer account or for the member's proprietary account. The time of order entry, trade matching, and any order modifications are automatically included. The Trading System automatically records the time and other information of every order entered.

The time of each trade recorded by the Trading System is unalterable by CCFE users. Similarly, no order can subsequently be erased from the database. Although a member who enters an order that is resting in the system can cancel it or can change any order terms which are not matching criteria, the Trading System records the cancellation or modification without deleting the original order, and also records the member ID and trader ID of the system user making the cancellation or change.

CCFE maintains a record of all order and trade information in a database in Atlanta, Georgia. This complete electronic record gives the Exchange an unalterable audit trail that includes all of the details of every trade and order. It also provides NFA with the data necessary to conduct market surveillance, trade practice surveillance, and other regulatory functions described in this review.

The Exchange's database file is transmitted to NFA daily. On a trade-day-plus-one basis ("T+1"), NFA electronically compares each trading day's file with that day's cleared trade file transmitted to NFA by The Clearing Corporation to verify that all trade data in both files are identical. If any differences are found, NFA alerts the Exchange. Once the database file is verified, it is maintained by NFA in a database containing all CCFE audit trail data. CCFE also retains an electronic copy of the database file for each trading day.

## **2. HedgeStreet Futures Exchange**

All HedgeStreet trades are processed through the HedgeStreet Trading Engine ("Trading Engine") located in Chicago, Illinois.<sup>23</sup> Market participants communicate and place orders with the Trading Engine over the internet through a web-based interface. The Trading Engine executes orders in accordance with an algorithm that gives first priority to orders at best price, and then gives priority among orders at the same price on the basis of time of entry into the Trading Engine.

Each HedgeStreet member is permitted only one account number and has a unique user ID which he or she uses to access the Trading Engine.<sup>24</sup> Although the user ID is chosen by the member, it is linked to an Exchange-assigned account number that follows all activity by the member. The member's account number is recorded on every order that he or she places, and is visible to NFA to facilitate its surveillance work. Members who are business entities may have one or more authorized traders acting on their behalf. However, such traders must each have their own user ID, and that ID must be linked to the business entity's account number. In addition, authorized traders may not open their own accounts.

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<sup>23</sup> HedgeStreet's trading engine is hosted by the Chicago Board Options Exchange.

<sup>24</sup> HedgeStreet Rule 5.2.

Every order entered into the HedgeStreet Trading Engine identifies the member making the entry. The Trading Engine will not accept orders which do not include all order information required under Exchange rules. In addition to the user ID and password required for login, orders must include: the contract; delivery month; price; order type; quantity; time or period after which the order expires; account number or identifier; customer type indicator; and origin code showing whether the order is for a customer account or for the member's proprietary account. The Trading Engine automatically records the time and complete details of every order entered into the system.

The time of each trade recorded by the Trading Engine is unalterable by system users, and no order can subsequently be erased from the database. Although a member who enters an order which is resting in the system can cancel it or can change any order terms that are not matching criteria, the Trading Engine records every cancellation and modification without deleting the original order, and also records the user ID of the system user making the cancellation or change.

HedgeStreet maintains a record of all order and trade information at its Chicago hosting location. This complete electronic record provides HedgeStreet with a complete and unalterable audit trail that includes the details of every executed trade. The audit trail also provides NFA with the data necessary to deliver adequate regulatory services to HedgeStreet as described in this review. Data is transmitted to NFA daily. NFA maintains the data in a database that contains all HedgeStreet audit trail data. Audit trail data is also transmitted to HedgeStreet's San Mateo offices and archived on a daily basis. In addition, HedgeStreet's audit trail data is archived and taken to an offsite storage facility monthly.

### **3. United States Futures Exchange**

All USFE trades are processed through the USFE Trading Application ("Trading Application"), a fully automated electronic trading system. USFE members connect to the

Trading Application in one of two ways: either through dedicated lines or over the internet. In the case of dedicated lines, transmissions from members to the Trading Application are routed through USFE “entry points” in New York and Chicago. These specialized communications servers act as nodes for the dedicated lines and facilitate data flows between widely dispersed members and the central trading engine in Chicago. Secure internet connections typically function as backups to the dedicated lines.

Under USFE rules, orders may be entered into the Trading Application only by USFE members, by authorized employees of members or their affiliates (“authorized traders”), or through a member’s automated order routing system. Each order entered into the Trading Application identifies both the member and the authorized trader. The Trading Application executes trades in accordance with an algorithm that gives first priority to orders based on best price, and then gives priority among orders at the same price on the basis of time of entry into the Trading Application.<sup>25</sup>

USFE’s rules require that orders submitted to the Trading Application include the following information: the contract; delivery month of the contract; price; order type; quantity; time or period after which the order expires; account number or identifier; customer type indicator; and origin code showing whether the order is for a customer account or for the member’s proprietary account. The Trading Application automatically records the time and complete details of every order entered into the system. This information is recorded simultaneously in two databases located in separate facilities.

The time of each trade recorded by the Trading Application is unalterable by system users, and no order can subsequently be erased from the database. Although a member who

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<sup>25</sup> USFE Rule 404(a).



enters an order that is resting in the system can cancel it or can change any order terms which are not matching criteria, the Trading Application will record the cancellation or modification without deleting the original order, and will also record the user ID of the system user entering the cancellation or change.

USFE's audit trail file is transmitted to NFA daily. NFA maintains the file in a database that contains all USFE audit trail data. On a T+1 basis, NFA electronically compares each trading day's file with that day's cleared trade file also transmitted to NFA to verify that relevant trade data in both files are identical. If any differences are found, NFA alerts the Exchange. Once the database file is verified, it is maintained by NFA in a database containing all USFE audit trail data. USFE also retains an electronic copy of the database file for each trading day, which is backed up to tape nightly.

## **B. Safe Storage**

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. Acceptable methods of record retention include electronic storage media for both the two and five year periods.

### **1. Chicago Climate Futures Exchange**

The complete CCFE audit trail is stored in numerous places. Copies are maintained in Atlanta, at CCFE's own data center/disaster recovery site in the Chicago area, and with NFA.<sup>26</sup> The file is transmitted to CCFE's data center on an end-of-day basis. In addition, the Exchange backs up its audit trail data and stores it in a bank vault monthly. The vault contains all audit

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<sup>26</sup> NFA's safe storage practices are detailed below.

trail data from the inception of CCFE trading in December 2004. With respect to Commission Regulation 1.31, which requires 5-year storage of certain books and records, including trade data, the Exchange has been in operation less than five years and, as noted above, has thus far maintained all audit trail data.

## **2. HedgeStreet Futures Exchange**

The complete HedgeStreet audit trail is stored in numerous locations. During the target period, in addition to NFA, audit trail data was also transmitted to HedgeStreet's San Mateo offices and backed-up on tape nightly. Additional back-ups were conducted monthly and quarterly. Back-up tapes were to be retained for at least five years, in compliance with Regulation 1.31. Since HedgeStreet had been in operation for less than five years, a complete history of the Exchange's audit trail has been retained.

## **3. United States Futures Exchange**

USFE's primary Trading Application servers are located in separate facilities in the Chicago area. Trades and orders are simultaneously recorded at both facilities, allowing each to serve as a back-up to the other. If one facility were to fail, trading could continue at the other within one minute. Information is stored at the two Trading Application servers for five days. After that, it is transferred to tape and stored at two different sites for 10 years. In addition, another copy is sent to Deutsche Borse Systems in Germany. As with the other exchanges, copies of USFE's audit trail are sent to NFA on a daily basis.

## **4. NFA**

The three exchanges' safe storage capabilities and compliance with Commission Regulation 1.31 is buttressed by duplicative storage and record retention at NFA, which maintains each day's trading database file on its Chicago office servers. NFA also creates daily back-up tapes of the previous day's trading and sends these off-site each morning. Finally, NFA

maintains a back-up server at a hot site that includes the past six months of Exchange trade data. The back-up server can be accessed immediately in the case of an emergency. In the event of a complete failure in NFA's production servers, the entire database could be restored from tape within 72 hours at the hot site.

### **C. Conclusion**

The Division found that CCFE, HedgeStreet, and USFE each maintains an adequate audit trail and recordkeeping program. All three exchanges maintain a complete electronic record of all entries into their trading engines, which allow full reconstruction of trading history. In addition, any order cancellations or modifications are recorded. Each exchange also has adequate procedures in place for safe storage of audit trail data.

Based on the foregoing, the Division has no recommendations with respect to HedgeStreet's CCFE's and USFE's audit trail programs.

## **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. Trade practice surveillance may be conducted by the contract market itself, or through delegation to a third party, as was done by CCFE, HedgeStreet, and USFE during the target period.

An acceptable trade practice surveillance program should have systems that maintain all data reflecting the details of each transaction executed on the contract month. 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.

#### **A. Surveillance Tools**

NFA provides daily trade practice surveillance for CCFE, HedgeStreet, and USFE markets. NFA's TAPS system, whose use in market surveillance is described above, is also NFA's primary trade practice surveillance tool. TAPS generates trade practice exception reports when trading behavior exhibits suspicious patterns or breaches pre-programmed parameters. These exception reports identify potential violative conduct and alert NFA staff to matters that require further review. NFA staff review all TAPS exception reports on a daily basis. Due to low trading volumes at CCFE, HedgeStreet, and USFE during the target period, NFA was in fact able to review almost all trading on a daily basis.

The exception reports generated by TAPS are catalogued according to the violations they are designed to detect. Common reports include, for example, the Simple Wash Trade

Report, the Direct Cross Report, and the Counter Party Trade Percentage Report.<sup>27</sup> Through such reports and others, TAPS can detect wash trading; direct and indirect trading ahead of customer orders; direct and indirect crossing of orders; and marking the close. Other common violations detectable by TAPS include pre-arranged trading, money passes, and preferential trading. TAPS is also used to monitor for unusual error account activity; anomalous transfer trades; adjustments, or trade cancellations; and anomalous block trades or EFPs.

In addition to automated exception reporting, NFA also uses TAPS to conduct customized queries of audit trail data. For example, staff has the flexibility to tailor queries based on the time of transaction, order type, quantity, price, *etc.* Once NFA staff move beyond their initial review of an automated alert to a more detailed examination of potential trading abuses, the ability to organize and mine trade data greatly facilitates staff's research and analysis. TAPS also is used to reconstruct trading.

Another important TAPS function is the "trader profile," which provides NFA with the key characteristic practices of specific traders on an exchange. Trader profiles include average time logged on, average number of trading days per month, frequency of trading, average trade size, profit and loss history, frequent counterparties, and percentage of total volume in a given market. TAPS exception reports alert NFA to deviations from a trader's profile, such as those involving unusual profit patterns, significant changes in volume, unusual concentrations of trading activity between the same counterparties, and unusual error account activity.

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<sup>27</sup> The Counter Party Trade Percentage Report was a key report that helped NFA discover certain abuses of USFE's trading incentive programs. As discussed below in Section VII, subsequent investigation and disciplinary proceedings resulted in significant sanctions levied by USFE against market participants.

## **B. Inquiries and Investigations**

### **1. Initiation of Inquiries and Investigations**

NFA staff reviews TAPS exception reports for CCFE, HedgeStreet, and USFE on a daily basis. NFA can dismiss an exception immediately, with appropriate electronic documentation through TAPS' notes function, if it deems the exception unfounded. However, if NFA determines that an exception requires further scrutiny, then it will initiate an "inquiry." During an inquiry, NFA may request information and documents from relevant parties. Inquiries may be closed administratively, or, for minor rule violations, they may be closed with the issuance of reminder letters.

If an inquiry reveals more serious trading violations or violations of exchange rules, then a formal investigation may be opened. At this juncture, differences in the Regulatory Service Agreements between NFA and the three exchanges gain some importance, as the agreements govern how an investigation is opened and managed at each exchange. As described in detail below, the differences in the agreements pertain primarily to the technical delineation of roles and authority between NFA and the exchanges in conducting investigations. In practice, however, the relationship between NFA and each exchange's compliance staff is cooperative and collaborative. Under the respective agreements, NFA meets monthly with each exchange via telephone or in person, and typically NFA meets with each exchange more often. Such meetings may be driven by specific inquiries or investigations, proposed new contracts, specific market conditions requiring special coordination, and other developments.

**a. HedgeStreet and USFE**

The decision to elevate an inquiry into a formal investigation at HedgeStreet and USFE is made by the exchanges' in-house compliance departments. HedgeStreet and USFE may decide not to investigate and close the matter; to conduct their own investigation; or that NFA should investigate. Any exchange decision not to investigate must be explained in writing.

With respect to Hedge Street, NFA's Senior Manager for Trade Practice/Market Surveillance exercises discretion over inquiries, but not investigations. The Senior Manager can initiate inquiries as necessary and close them administratively when appropriate. If, after completing an inquiry, the Senior Manager believes that the matter should be expanded to a formal investigation, it will be forwarded to HedgeStreet with a recommendation to that effect. If HedgeStreet's Compliance Director fails to conduct or authorize an investigation, then the Compliance Director will to notify NFA in writing of this decision and the reasons for it.<sup>28</sup>

NFA exercises similar discretion at USFE as it does at HedgeStreet. NFA may open inquiries, and close them administratively, as it deems appropriate. If NFA's Senior Manager for Trade Practice/Market Surveillance believes that an inquiry should become a formal investigation, then a recommendation to that effect must be made to USFE's Compliance Department. If USFE rejects the recommendation, then it must prepare a letter to NFA describing its decision and the reason for it.

**b. CCFE**

Under its Regulatory Services Agreement with CCFE, NFA has the authority to open a formal investigation whenever it discovers or receives a referral concerning a possible CCFE rule violation, or whenever the results of an inquiry indicate a possible violation of a CCFE rule.

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<sup>28</sup> NFA-HedgeStreet Regulatory Services Agreement, Schedule A, Section IV(B)(3).

NFA informs CCFE Compliance by telephone or e-mail whenever it initiates an inquiry or investigation, and provides CCFE with quarterly reports detailing the number and types of inquiries and investigations conducted, the parties involved, and how the matters were resolved.

Decision-making authority with respect to inquiries and investigations on CCFE markets rests with NFA's Senior Manager for Trade Practice/Market Surveillance. The Senior Manager may close an inquiry administratively or expand it into an investigation. He can also close an investigation administratively or refer it to CCFE for consideration of charges. If the Senior Manager does refer an investigation, then CCFE Compliance determines whether a disciplinary action should be commenced. In practice, decisions to open inquiries and investigations are made in consultation between NFA and the Exchange. If CCFE were to reject a recommendation made by NFA, then NFA would request a written explanation. However, in the time that NFA has provided regulatory services for CCFE, the Exchange has never rejected a recommendation to open an inquiry or an investigation.

## **2. NFA Documentation and Tracking of Inquiries and Investigations**

NFA records and tracks all inquiries and investigations through its computerized Financial Analysis, Audit, and Compliance Tracking System ("FACTS"), which also provides electronic document retention functionality. FACTS assigns each inquiry or investigation a separate identification number, and records the name of the initiating NFA staff member. It also classifies all inquiries or investigations as either generated by NFA, or resulting from a member or anonymous complaint, or a Commission referral. FACTS also notes the relevant exception reports involved in the matter. For each inquiry or investigation, FACTS maintains the date of each significant investigative action, including the dates the matter was opened and closed, as well as the dates of each information request, interview, or other investigative step.



NFA uses FACTS to electronically document all work completed in an inquiry or investigation. Specifically, staff uses FACTS to maintain copies of all inquiry and investigation notes, all documents requested or reviewed, and transcripts or summaries of all witness interviews. Documents submitted in electronic form are retained in FACTS as submitted. If documents are submitted in paper rather than electronically, NFA scans the documents into FACTS and retains the paper copies. Witness statements, if any, are taken by telephone, tape-recorded, and either summarized or transcribed. Once a statement is summarized or transcribed, the witness and the compliance officer of the member firm involved review the document and sign it to verify the written record's accuracy. The transcript or summary is then maintained in FACTS, and also retained in paper form, along with the tape recording of the interview. The complete record of an inquiry or investigation can be reviewed in or printed out from FACTS.

At the conclusion of any inquiry or investigation, NFA staff record a brief summary of the matter in FACTS, including the reason the inquiry or investigation was initiated, the facts discovered, the documents reviewed, any statements taken, and the disciplinary history (if any) of the parties involved. The summary also includes NFA's conclusions and any recommendations for further action.

### **3. Adequacy of Inquiries and Investigations**

#### **a. Chicago Climate Futures Exchange**

CCFE conducted one inquiry and no investigations during the target period. The inquiry arose when a TAPS exception report noted a potential instance of trading ahead of a customer order. NFA closed the inquiry administratively when its review revealed that an improperly coded account caused the exception.

During the target period, there were numerous exceptions related to high counterparty trade percentages—*i.e.*, unusually frequent trading between two parties. NFA found that this

was attributable to CCFE's low trading volume and the fact that only a small number of traders were present in the market on any given day. There also were 41 wash trade exceptions generated at CCFE during the target period, with the majority occurring in spread trades.<sup>29</sup> In each instance, CCFE contacted the identified trader, determined that the wash trade had been executed inadvertently, and busted the trades.

**b. HedgeStreet Futures Exchange**

NFA referred 11 matters to HedgeStreet for formal investigation by the Exchange during the target period. Of the 11 investigation referrals, four involved possible off-market entry of orders by market makers. The four investigations were closed with findings of no violations. HedgeStreet and NFA determined that in each instance, the orders had been entered due to problems with the computer models used by the market makers and that there was no violative intent.

Six of the investigation referrals involved customers entering into pre-arranged trades of low-priced options in order to obtain an iPod Shuffle in a HedgeStreet marketing promotion.<sup>30</sup> In each instance, HedgeStreet sent warning letters to the members involved, informing them that they had violated the Exchange's prohibition against pre-arranged trades. The customers were not awarded their iPods.

The most serious investigation referral during the target period involved pre-arranged trading between two HedgeStreet members. Over the course of several transactions, these members passed money from one member's account to that of the other to repay a \$6,900 loan. As part of the investigation, HedgeStreet and NFA interviewed both members and reviewed

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<sup>29</sup> More specifically, the trading engine's implied spread functionality matches one leg of a spread order against an outright order entered by the same trader.

<sup>30</sup> In its iPod Shuffle promotion, HedgeStreet offered iPod Shuffles to market participants who opened an account at HedgeStreet, funded the account with at least \$100.00, traded during the promotion period, and did not violate HedgeStreet rules or the Act. The promotion period was November 16, 2006 through December 29, 2006.

relevant documents. Both individuals admitted to pre-arranging their trades and passing money. They explained that they worked together in the insurance business, sat next to each other during the trading, and chose illiquid contracts to facilitate their plan. They claimed to be unaware that pre-arrangement of trades was a violation of Exchange rules. HedgeStreet sanctioned the two members via reminder letters stating that they had violated the Exchange's prohibition against pre-arranged trades. The two reminder letters were issued administratively, not as a result of a formal disciplinary hearing.

When questioned by Division staff regarding the decision not to refer the matter for formal disciplinary action and to issue such a limited sanction, Hedge Street staff explained that the decision was based on several factors. As a general premise, HedgeStreet asserted that its members typically have very little futures trading experience; that they may be less sophisticated than traditional futures exchange members; that they are unaccustomed to placing orders directly on an exchange, and thus, are unaware of the rules by which members must abide. In addition, HedgeStreet cited specific circumstances with respect to the case in question: that the members were unaware that their activity was wrongful; that under the applicable state insurance laws a formal penalty would be a "disclosable event" to the members' employers, with potentially adverse repercussions to the members; and that no other HedgeStreet members were impacted by the pre-arranged trades.

After careful consideration, the Division believes that HedgeStreet's rationale is unpersuasive. The Division believes that the matter should have been referred for formal disciplinary action and that warning letters in this case were inadequate. Pre-arranged trading to effectuate money-passing is a serious trade practice offense. The focus on this offense by financial regulators, including the Commission, has intensified in recent years in view of

concerns with money laundering and its national security implications. The Division also believes that HedgeStreet’s general argument—that its members are typically less experienced and less sophisticated—is no excuse for violations of HedgeStreet rules. Furthermore, the Division believes that the employment consequences of an exchange sanction should not play a role in determining whether to refer a matter for disciplinary action or the disciplinary process.

The Division also questions the two members’ stated reason for the pre-arranged trade: to pass money as a way for one member to payoff a loan made by the other. There are more conventional ways to pay loans that do not involve pre-arranged trading in the futures markets. Although HedgeStreet, like any other exchange, has discretion with respect to referring a matter for disciplinary action and the sanctions it imposes, the Division believes that an administrative reminder letter was wholly inadequate in this case. The Division recommends that any similar cases that may arise in the future—cases characterized by substantive trade practice violations (such as pre-arranged trading) carried out over a number of trades to effectuate a questionable outcome (money-passing)—be handled through HedgeStreet’s formal disciplinary process and that appropriate sanctions be levied.

Finally, HedgeStreet staff responded to 11 member complaints during the target period, the majority involving the settlement prices used at contract expirations or technical system issues. The Division believes that the Exchange’s responses were adequate.

### **C. United States Futures Exchange**

NFA opened 11 inquiries and two trade practice investigations involving trading on USFE during the target period, all of which resulted from staff review of TAPS exception reports. The two trade practice investigations involved instances of potential wash trading and resulted from elevated percentages of intra-firm trading which occurred during an Exchange

volume-based incentive program. Both investigations were referred for disciplinary action and resulted in sanctions of \$75,000 and \$30,000, respectively.<sup>31</sup>

NFA found that USFE members and their traders were executing potential wash trades to benefit from an Exchange incentive program. The incentive program, known as the Early Volume Adopter program, guaranteed revenue sharing based on a member's accumulated volume from January 18 through August 31, 2005. Specifically, the incentive program required participants to trade at least 3,000 contracts per day for at least 15 trading days per month. In both investigations, intra-firm volume at both member firms rose significantly and appeared to coincide with the USFE's incentive program. Following identification of the two firms' abusive trading strategy, they were notified that this was contrary to the intent of the program, and a significant portion of the resulting volume from these trades was subtracted from the calculation of the incentive program bonuses paid to each firm.

The Division reviewed both trade practice investigations and found that they included appropriate analysis and were appropriately expanded in scope to identify all possible patterns of trading violations. In addition, the investigations were well documented and completed in a timely manner. Moreover, the Division commends USFE for its proactive response in notifying Division staff of questionable trading related to the incentive program. The Exchange also issued a regulatory bulletin reminding members of appropriate trading practices.

The nine NFA inquiries that did not result in referrals to USFE involved review of EFPs, block trades, and give-up transactions. These inquiries were appropriately documented in the USFE's investigations and inquiries log.

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<sup>31</sup> See Section VII below for further discussion of the related disciplinary cases.

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

The Division found that CCFE, HedgeStreet, and USFE maintain adequate trade practice surveillance programs. NFA, which provides trade practice surveillance for all three exchanges, reviews automated exceptions reports and other information daily to identify potential trading abuses. NFA also has the ability to query exchange trade data in a customized, flexible manner and to construct trader profiles for market participants. Through FACTS, NFA records and tracks every inquiry and investigation at each exchange.

The authority granted to NFA by each exchange varies. However, NFA is always permitted to conduct inquiries and to recommend investigations where appropriate. NFA may conduct CCFE investigations of its own accord. USFE and HedgeStreet investigations require authorization by the relevant exchange. Should such authorization be denied, the exchange must provide a written explanation to NFA.

During the target period, NFA opened 11 inquiries and two trade practice investigations at USFE. Both investigations were thorough, well documented, and included significant analysis. Both also led to disciplinary charges against the parties involved. With respect to CCFE, there were no trade practice investigations at the Exchange during the target period, and only one inquiry.

Finally, in the case of HedgeStreet, NFA referred 11 matters to the Exchange for formal investigation during the target period. Six were resolved through warning letters and four were closed with findings of no violations. One matter was resolved through administrative reminder letters that the Division believes were wholly inadequate sanctions. The parties admitted to passing money from one HedgeStreet member's account to that of another HedgeStreet member

via pre-arranged trading. Given this conduct, the Division finds that the grounds for leniency articulated by HedgeStreet are unpersuasive.

**Based on the foregoing, the Division recommends that HedgeStreet:**

- **Refer completed investigations for formal disciplinary action when the Exchange concludes that there is sufficient evidence of substantive trading violations.**

## **VII. DISCIPLINARY PROGRAMS**

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

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

Core principle 2 requires that exchanges take effective disciplinary action whenever a rule violation is suspected. Disciplinary actions must be prompt and conducted pursuant to clear and fair standards. Exchanges must have the authority to discipline, suspend, or terminate the activities of members or market participants found to have committed rule violations.

#### **A. Chicago Climate Futures Exchange**

##### **1. Disciplinary Committees**

CCFE's disciplinary program includes three different disciplinary committees: the Review Panel, the Disciplinary Panel, and the Appeals Panel. Each panel has a unique role in the disciplinary process. The Review Panel considers investigation reports and determines whether charges should be brought against potential disciplinary respondents. The Disciplinary Panel conducts hearings in connection with any disciplinary proceeding, makes findings, and imposes sanctions. If charges are brought, and a rule violation is found by the Disciplinary Panel, the respondent may appeal to the Appeals Panel within 20 days. The Review and Appeals Panels are appointed by CCFE's board of directors; each consists of three Trading Privilege

Holders serving one-year terms. The Disciplinary Panel also is appointed by the board of directors and consists of five Trading Privilege Holders.

## **2. Disciplinary Proceedings**

CCFE's Market Regulation Department has the authority to initiate and conduct inquiries and investigations and to prepare investigative reports. It may also recommend disciplinary proceedings and prosecute alleged violations of Exchange rules. As described above, CCFE has contracted with NFA for regulatory services, including those associated with disciplinary proceedings. Thus, for example, inquiries, investigations, and the preparation of investigative reports may be conducted by either CCFE or NFA. Decisions regarding the disposition of investigations are made by CCFE.<sup>32</sup>

For each potential respondent, the Review Panel determines whether to authorize the commencement of disciplinary proceedings, close the matter without action, or dispose of it informally (by issuing a warning letter or otherwise).<sup>33</sup> If the Review Panel authorizes disciplinary proceedings, then the Market Regulation Department will prepare and serve a notice of charges. The notice will state the acts that the respondent is alleged to have engaged in, the CCFE rule alleged to have been violated, the proposed sanctions, and advise the respondent of its right to a hearing.<sup>34</sup> A respondent's written and signed answer to a notice of charges must be filed within 20 days, and must address each allegation. A respondent's failure to timely answer a notice of charges will be deemed an admission. In addition, any allegation that a respondent fails to expressly deny will be deemed admitted.<sup>35</sup>

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<sup>32</sup> CCFE Rules 702 and 710(b).

<sup>33</sup> CCFE Rule 705.

<sup>34</sup> CCFE Rule 706.

<sup>35</sup> CCFE Rule 707.



A respondent may propose an offer of settlement to disciplinary proceedings. Settlement offers should contain proposed findings and sanctions, and be signed by the respondent and submitted to the Market Regulation Department. The Market Regulation Department will forward the proposed offer to CCFE's General Counsel, with a recommendation for accepting or rejecting the offer. Settlement offers that are accepted become final after 20 days, and a respondent's submission of the offer is deemed to constitute a waiver of the right to appeal.<sup>36</sup>

All CCFE disciplinary hearings, except for the summary impositions of fines, are conducted before the Disciplinary Panel. During the course of a hearing, the Market Regulation Department and all respondents may present evidence and facts, call and examine witnesses, and cross-examine witnesses called by other parties. Respondents are permitted the assistance of counsel.<sup>37</sup> Any hearing conducted in connection with disciplinary proceedings will be recorded.<sup>38</sup>

Following a hearing, the Disciplinary Panel will issue an order rendering its decision. Decisions are made by majority vote. Unless a timely notice of appeal is filed, a disciplinary decision becomes final after 20 days.<sup>39</sup> The Exchange may impose a fine of up to \$500,000 for each rule violation.<sup>40</sup>

Respondents found to have violated a rule may appeal the Disciplinary Panel's decision within 20 days to the Appeals Panel. The Appeals Panel's written order is CCFE's final action and is not subject to further appeal within the Exchange.<sup>41</sup>

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<sup>36</sup> CCFE Rule 709.

<sup>37</sup> CCFE Rule 701(e).

<sup>38</sup> CCFE Rule 713.

<sup>39</sup> CCFE Rule 714.

<sup>40</sup> CCFE Rule 715.

<sup>41</sup> CCFE Rule 717.

### **3. Disciplinary Sanctions**

There were no disciplinary cases at CCFE during the target period.

#### **B. HedgeStreet Futures Exchange**

##### **1. Hearing Officer and Appeals to the Board**

HedgeStreet does not have traditional exchange disciplinary committees. Instead, the Exchange will contract on an “as-needed” basis with attorneys who specialize in commodities regulation to serve as Hearing Officers. HedgeStreet did not have a need to contract with hearing officers during the target period or prior to it. As described below, HedgeStreet rules guide the procedures and process in which a Hearing Officer must engage when hearings occur. Although HedgeStreet does not have a formal appeals panel, both the Compliance Department and the respondent may appeal the Hearing Officer’s decision to the HedgeStreet board of directors.

##### **2. Disciplinary Procedures**

Inquiries, investigations, and investigation reports may be prepared by either HedgeStreet or NFA. Decisions regarding the disposition of investigations are made by HedgeStreet. Upon the conclusion of any investigation, the Exchange will draft a document detailing the cause of the investigation, its findings, and the Compliance Officer’s analysis and conclusions. If the Exchange finds that a reasonable cause exists to believe a member has violated HedgeStreet’s rules, then the member under investigation will receive a report detailing why the investigation was started, the charges, the response, if any, a summary of the investigation, the Compliance Officer’s findings and conclusions as to each charge, and the proposed sanction (if any).<sup>42</sup>

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<sup>42</sup> HedgeStreet Rule 9.2(b).

The member whose activity is the subject of the investigation may contest the findings by forwarding a response to the Compliance Officer within 15 days. The member's response must contain a detailed response to the findings and conclusions for each charge.<sup>43</sup> If the Compliance Officer's findings are not contested, HedgeStreet will deem those findings admitted and impose the penalty (if any) proposed by the Compliance Officer.<sup>44</sup>

In the case of contested findings, HedgeStreet will submit the Compliance Officer's report and the member's response to a HedgeStreet Hearing Officer. The Hearing Officer will conduct a telephonic hearing with the Compliance Officer and the member within 20 days of the member's response, and within 20 days after that hearing, issue findings. Such findings include a description of the allegations, a summary of the evidence, findings and conclusions, a declaration of any penalty to be imposed, and the effective date of the penalty.<sup>45</sup>

The member or the Compliance Officer may appeal the Hearing Officer's findings to HedgeStreet's board of directors within 15 days. The board of directors will review the hearing record, consider any information submitted by the member and/or the Compliance Officer on appeal, and render a final decision.<sup>46</sup>

HedgeStreet may also enter into a settlement agreement with any member who is the subject of an investigation. Any settlement offer submitted by a member shall be forwarded to a Hearing Officer with a recommendation by the Compliance Officer as to whether the settlement

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<sup>43</sup> HedgeStreet Rule 9.2(c).

<sup>44</sup> HedgeStreet Rule 9.2(d).

<sup>45</sup> HedgeStreet Rule 9.2(e).

<sup>46</sup> HedgeStreet Rule 9.2(f).

should be accepted, rejected, or modified. The Hearing Officer may accept, reject, or offer a modification to the proposed settlement.<sup>47</sup>

As a result of a disciplinary proceeding or as part of a settlement agreement, HedgeStreet may impose penalties, including a letter of warning, a fine, suspension of membership, or revocation of membership privileges.<sup>48</sup>

### **3. Disciplinary Sanctions**

There were no disciplinary cases at HedgeStreet during the target period. However, HedgeStreet issued 258 warnings and 248 summary fines against members who entered orders with insufficient funds in their accounts. The fines totaled \$2,355.43.<sup>49</sup>

## **C. United States Futures Exchange**

### **1. Disciplinary Committee**

USFE has a Disciplinary Committee that is authorized to determine whether violations of USFE rules have been committed, to set and impose appropriate penalties, and to accept settlement offers. The Disciplinary Committee consists of USFE officers or employees appointed by the Chief Executive Officer. Its decisions are final and not subject to appeal within USFE.<sup>50</sup>

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<sup>47</sup> HedgeStreet Rule 9.3.

<sup>48</sup> HedgeStreet Rule 9.5.

<sup>49</sup> The fines for insufficient funds ranged from \$0.29 to \$10.00. As noted previously, entering orders with insufficient funds poses little risk to HedgeStreet markets because the trading system will not allow such orders to be matched. Exception reports alert staff to under-funded orders. Hedge Street typically sends offending members reminder letters, warning letters, and then applies a summary fine schedule. Summary fines range from \$10 for the first offense in a calendar year to \$30 and a revocation of trading privileges for six offenses in one calendar year. The fourth and fifth violations carry suspensions of 30 and 180 days, respectively. Any fines under \$10 represent insufficient funds in the member's account to collect the full amount.

<sup>50</sup> USFE Rule 203.

## 2. Disciplinary Procedures

As described above, USFE has contracted with NFA to provide regulatory services. Potential inquiries and investigations and the preparation of investigative reports may be conducted by either USFE or NFA. Decisions regarding the disposition of investigations are made by USFE.

The USFE Compliance Department is responsible for investigating possible violations of USFE rules. After conducting an investigation, staff prepares a written report including the reason the investigation was initiated, a summary of the complaint, if any, the relevant facts, and staff's conclusions. If a reasonable basis exists for finding a violation, staff will make a recommendation as to whether the Disciplinary Committee should proceed with the matter. Within 30 days of receiving a completed investigation report, the Disciplinary Committee must either determine that no reasonable basis exists for finding a violation, or determine that a reasonable basis exists for finding a violation.<sup>51</sup> If the Disciplinary Committee concludes that there is a reasonable basis for finding a rule violation, a written notice of charges is then served by USFE on the respondent.<sup>52</sup>

Respondents' answers must be in writing and include a statement that they admit, deny, or are without sufficient knowledge to form a belief as to the truth of each allegation. Failure to serve an answer within 30 days is deemed an admission of all allegations. If a respondent admits or fails to deny any of the charges, the Disciplinary Committee may find that the violation of rules alleged has been committed and may impose a penalty.<sup>53</sup>

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<sup>51</sup> USFE Rules 601-603.

<sup>52</sup> USFE Rule 605.

<sup>53</sup> USFE Rule 607.

If a respondent requests a hearing, it will be conducted before a panel of three members of the Disciplinary Committee (Hearing Panel”).<sup>54</sup> USFE’s Compliance Department will be a party to the hearing and will present its case on the charges and penalties which are the subject of the hearing. The respondent is entitled to call witnesses and to present such evidence as may be relevant to the charges or the penalties.<sup>55</sup> Following a hearing, the Hearing Panel must render a written decision. The decision is final and not subject to appeal within USFE.<sup>56</sup>

A Hearing Panel may impose any one or more of the following penalties: a censure or reprimand; a fine in an amount that the Hearing Panel deems appropriate; limitation on the positions that the respondent may carry or hold; suspension of trading and/or clearing privileges; denial of future access, either directly or indirectly, to USFE for such period as the Hearing Panel determines, suspension as a clearing member or as a member; and termination as a clearing member or as a member.<sup>57</sup>

Respondents may file written settlement offers to resolve a matter. The Disciplinary Committee may accept or reject the settlement offer. If the Disciplinary Committee accepts a settlement offer, it must issue a written decision specifying the violations it has reason to believe were committed and any penalty to be imposed.<sup>58</sup>

### **3. Disciplinary Sanctions**

NFA referred three investigations to USFE for disciplinary action during the target period. The three investigations involved two clearing member firms and one trading member firm, as well as certain employees and independent contractors trading on behalf of the members.

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<sup>54</sup> USFE Rule 609.

<sup>55</sup> Id.

<sup>56</sup> USFE Rule 610.

<sup>57</sup> USFE Rule 611.

<sup>58</sup> USFE Rule 613.

The Disciplinary Committee issued charges only against the member firms, and all three of the resulting cases were subsequently resolved through settlement agreements. Two of the cases involved improper trading under a USFE incentive program, and the third case involved improper execution and reporting of an EFP transaction. In the incentive program cases, the Exchange levied fines of \$75,000 against a clearing member firm and \$30,000 against a trading member firm for conduct detrimental to the best interests of the Exchange. Neither firm had a prior disciplinary history with the Exchange. In the EFP case, the Exchange levied a \$3,000 fine against a clearing member firm which previously had been issued a warning letter for similar conduct.

The Division believes that the sanctions levied in all three disciplinary cases were adequate.<sup>59</sup> Furthermore, as noted previously, the Division commends USFE for its proactive response in notifying Division staff of questionable trading related to the incentive program. In this connection, the Division notes that the concerns raised and recommendations made in this USFE disciplinary discussion apply to the Exchange's Disciplinary Committee and not to its Compliance Department.

With respect to the Disciplinary Committee and the two incentive program cases, it appears that the Committee may not have fully understood what constitutes wash trading or the relevant factors to be considered in a wash trading analysis. In addition, the minutes for both cases fail to demonstrate that the committee considered and deliberated regarding all the rule violations alleged by NFA, or considered issuing charges against all of the parties recommended by NFA. Finally, in one of the incentive program cases, NFA did not recommend charges

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<sup>59</sup> The Division notes that the Exchange's incentive program payments did not include payment for the improper trading described below.

against the firm's traders because the traders were independent contractors, and, as such, neither NFA nor USFE believed that the Exchange's rules provided for jurisdiction.

**a. Overview of Incentive Program Cases**

The broad outlines of the two incentive program cases, 2005-MINV-00226 ("Case 226") and 2005-MINV-00243 ("Case 243"), are similar. Both cases focused on potential wash trading by member firms in an effort to qualify for volume-based trading incentives. The incentive program targeted U.S. Treasury futures contracts and was described in a January 5, 2005 memorandum distributed to all Exchange members. The memorandum stated that there would be a guaranteed minimum incentive pool of \$5 million.

The respondent in Case 243 was a USFE member firm that engaged only in proprietary trading. NFA also investigated and recommended charges against five traders employed by the firm and the firm's primary equity holder, who also traded on its behalf. NFA began heightened surveillance in this matter on January 19, 2005, the day after the incentive program began. NFA staff noted that a significant amount of the firm's volume was "intra-firm volume."<sup>60</sup>

Further investigation by NFA revealed that the firm's traders were implementing what the firm referred to as a "scratch" trading strategy. The scratch strategy was defined as one in which "upon execution of an opening position the trader would immediately, or within one or two seconds, place an opposite and offsetting order...at the same price as his opening position." NFA noted that the scratch strategy "did not appear to allow the trader to ever profit from

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<sup>60</sup> Specifically, NFA found that 56 percent of the firm's January 18 volume was intra-firm volume. Intra-firm volume was defined as "trades with one of the two following attributes: an Authorized Trader of [an Exchange member] executing both the buy and the sell side of a transaction; or an Authorized Trader of a member executing a transaction with another Authorized Trader of the same [exchange member]." NFA initiating memo dated January 19, 2005. Subsequent intra-firm volume at the firm remained high. For example, on January 20 it was 59 percent and on January 24 it was 56 percent. On other days, intra-firm volume percentages in the 50s, 40s, and 30s were observed, as well as multiple days in the mid-twenties and high teens.



trading.”<sup>61</sup> NFA also noted that the firm’s traders tended to trade the same contracts, at the same time, and in identical 10-lot orders. In numerous instances, a trader’s scratching occurred against his own orders. Interviews with the firm’s principal, who designed the strategy, revealed its intent. He indicated that the strategy would allow the firm’s traders to cover their operation costs because the expectation was that the incentive payments would be greater than the firm’s infrastructure costs plus any trading losses. NFA concluded that the scratch trading strategy amounted to wash trading.

Case 226 was very similar to Case 243, albeit with perhaps more direct instructions from the clearing member firm to its traders as to how they could implement the scratch strategy and profit from the incentive program rather than from trading. In this case, the firm’s traders were independent contractors who worked for a percentage of their trading profits. More significantly, the firm also offered compensation based on the incentive program.

The presence of contract traders in Case 226 is significant because it deterred the Exchange from pursuing charges against the firm’s traders. The Exchange explained to Division staff that it “did not have the personal jurisdiction over those traders because they were independent contractors....”<sup>62</sup> Similarly, NFA’s investigation report stated that “the individual traders are not recommended for charges as they are not employees of the firm.” The Division believes that whether a trader is an employee, contractor, or otherwise associated with a member firm should have no bearing on an exchange’s exercise of jurisdiction over such trader in the event of wrongdoing.

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<sup>61</sup> NFA “Investigative Summary.”

<sup>62</sup> USFE transcript.

In Case 226, the violative conduct first came to NFA’s attention when two of the firm’s traders registered extremely high intra-firm counterparty percentages on January 28, 2005.<sup>63</sup> In the course of its investigation, NFA acquired an internal memorandum distributed by the firm to its traders. The memorandum was entitled “The Eurex US Bonus Scheme” (“bonus scheme” and “bonus scheme memo”) and described how traders could benefit from incentive payments made by the Exchange to the firm.<sup>64</sup> The bonus scheme memo included a chart that listed the bonus payments that traders would receive in return for certain volumes and hit rates. In effect, traders were rewarded even when they *lost* money—losses which the firm would cover, but were encouraged to lose no more than 1.4 ticks per round-turn.

**b. NFA Recommendations and Disciplinary Committee Action**

The Commission defines wash trading as “entering into...transactions to give the appearance that purchases and sales have been made, without incurring market risk or a change in the trader’s market position.”<sup>65</sup> Among other concerns, wash trading raises the possibility that the market will receive false price and volume signals. Wash trading is specifically prohibited in Section 4c(a) of the Act, which, *inter alia*, makes it “unlawful for any person to offer to enter into [or] enter into...a transaction...that is of the character of, or is commonly known to the trade as, a ‘wash sale’....”

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<sup>63</sup> On that day, 100 percent of trader X’s volume in the 10-year Treasury Note futures contract was against trader Y, and 87 percent of trader Y’s volume was against trader X. In describing their behavior, NFA found that the traders “appeared to utilize a strategy where once their resting order was transacted, they placed an equal offsetting order (priced the same as the transacted order) within zero to two seconds of the initial execution.” In its investigation report, NFA explained that “the result of this type of transaction was the creation of volume without apparent economic benefit other than EVA incentives.” NFA Investigative Summary, page 2. Additional analysis revealed that the firm’s intra-firm volume ranged from 27.6 percent to 38.3 percent in the time period January 18-31, 2005 (the incentive program was not available prior to January 18).

<sup>64</sup> The bonus scheme memo explained that, first, all traders would receive a guaranteed \$400 bonus for participating in the bonus scheme so long as they traded a minimum of 7,500 round-turn trades per month and had a “hit rate” of better than -1.50 percent. The hit rate was defined as the total ticks divided by the total round-turns. As an example, “a 1-tick loss in 1 round-turn would be -1.0 hit rate. A scratch trade would be a 0.0 hit rate. Second, the firm would cover all trading losses incurred by its traders. Third, traders would be allowed to retain any trading profits.

<sup>65</sup> CFTC Glossary.

The Commission has set forth the elements of a wash sale in its case law, including *In re ALFRED R. PIASIO and DONALD W. WILSON*, 2000 CFTC LEXIS 216 (September 29, 2000).

There, the Commission explained that:

In order to establish that a wash sale has occurred, the Division [of Enforcement] must initially demonstrate that the transaction at issue achieved a wash result. The factors that show a wash result are (1) the purchase and sale (2) of the same delivery month of the same futures contract (3) at the same (or a similar) price (citations omitted).

The Commission went on to explain additional factors that are also relevant in the USFE wash trade cases:

The other factors material to proof of a wash sale violation relate either to the customer's intent at the time the challenged transactions are initiated or to the participants' knowledge at the time they choose to participate. As to the first issue, the Division must demonstrate that the customer intended to negate risk or price competition. Price competition or market risk is negated "when it is reduced to a level that has no practical impact on the transaction at issue" (citations omitted). As to the second issue, the Division must show that at the time respondent chose to participate in the transaction, he knew that the transaction was designed to achieve a wash result in a manner that negated risk (citations omitted).

Relying on the Commission's definition, NFA determined that wash trading may have taken place in both USFE incentive program cases. The two member firms were thus in potential violation of Section 4c(a) of the Act and Exchange Rule 308(a), which requires Exchange members to "conform to applicable provisions of the Act." As NFA noted in its summary of Case 226:

Operating under contract to [the firm], the aforementioned traders all utilized a scratch strategy which involved periods of intrafirm trading amongst several [firm] traders that created buys and sells on the Exchange; which at the firm level **failed to carry risk**. The trades, when combined, offset any potential position, resulted in **no change of ownership**. It therefore, appears that [the firm] violated Eurex US Rule 308(a) (emphasis added).

NFA further concluded that the firm's memorandums to traders dictated a plan by which traders benefited from a strategy that generated trades without economic purpose and increased the number of wash trades. NFA made similar findings in Case 243.

NFA recommended that charges be brought against both firms. Specifically, NFA recommended that the charges include violation of Exchange Rules 308(a) (for wash trading), 308 (p) (conduct or practices inconsistent with just and equitable principles of trading or conduct or practices detrimental to the best interests of the Exchange), and other Exchange rules relating to, among other things, rule violations by employees and failure to supervise and train employees. NFA further recommended in Case 243 that charges be issued against five of the firm's traders and its primary equity holder.

In both cases, the Disciplinary Committee determined that the scratch trading strategy employed by the firms had the effect of trading with "little or no market risk," one of the two primary elements of the Commission's wash trading definition.<sup>66</sup> However, nothing in the committee's minutes for either case indicates that it considered the second element of the Commission's wash trading definition—no change in market position, which element was evident in NFA analysis before the disciplinary committee. The committee concluded that there was no reasonable basis for concluding that either firm violated Exchange Rule 308(a), *i.e.*, engaged in wash trading. The Disciplinary Committee found, however, that there was a reasonable basis for concluding that the firms engaged in conduct or practices inconsistent with just and equitable principles of trading or conduct or practices detrimental to the best interests of the Exchange.

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<sup>66</sup> Committee minutes.

The minutes for both cases document other factors considered by the committee in reaching its determination not to issue wash trading charges-- the firms did not pre-arrange their trades; the firms' conduct had no substantially adverse effect on price discovery; and that the firms' conduct did not result in harm to customers. The Division notes that these factors are not relevant to the Commission's definition of wash trading and believes that USFE should further educate its Disciplinary Committee regarding the relevant elements of wash trading.

As noted above, NFA also recommended that charges be brought against the firms for other potential rule violations related to their incentive program trading activity (*e.g.*, failure to train and supervise employees and rule violations by employees), and, that in Case 243, charges be issued against five of the firm's traders and its primary equity holder. The minutes for both cases offer no evidence that the Disciplinary Committee ever considered issuing the additional charges against the firms. Further, there is no evidence in the minutes for Case 243 that the committee considered issuing charges against the traders or the primary equity holder. Given that exchange disciplinary committees serve a critical role in enforcing an exchange's rules, USFE should take appropriate measures to ensure that its Disciplinary Committee deliberates regarding all rule violations alleged by NFA against all parties, and that committee minutes thoroughly articulate the committee's rationale for accepting or rejecting NFA's recommendations.

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

CCFE, HedgeStreet, and USFE maintain disciplinary programs that include appropriate disciplinary procedures. Each exchange has the authority to investigate possible rule violations, prosecute cases, and discipline members or market participants who are found guilty. Respondents receive adequate notice of the claims against them, and have sufficient opportunity

to present their defenses, call witnesses, and offer evidence. Respondents also are afforded the right to counsel, may enter into settlement negotiations, and may appeal unfavorable decisions to the respective exchange's board of directors.

Since there were no disciplinary cases at CCFE or HedgeStreet during the target period, the Division has no basis upon which evaluate the performance of their disciplinary processes. USFE levied sanctions in three cases during the target period. In one case involving improper execution and reporting of an EFP, USFE levied a \$3,000 fine. USFE levied a \$75,000 fine against a clearing member firm and a \$30,000 fine against a trading member firm for improper trading under a USFE incentive program.

The Division found that the sanctions levied in all three USFE cases were sufficient. However, as evidenced in USFE's incentive program cases, it appears that the Exchange's Disciplinary Committee may not have fully understood what constitutes wash trading as that term is defined by the Commission, or the relevant factors to be considered. The Division further found that the Disciplinary Committee's minutes did not demonstrate that the committee deliberated regarding all rule violations alleged by NFA against all parties. Finally, the Division found that NFA and USFE did not pursue charges against a firm's traders because the traders were independent contractors and USFE's rules do not provide for such jurisdiction.

**Based on the foregoing, the Division recommends that USFE:**

- **Ensure that its Disciplinary Committee members understand what constitutes wash trading, as defined by the Commission, and the relevant factors to be considered in a wash trading analysis.**
- **Ensure that Disciplinary Committee minutes demonstrate that the committee deliberated regarding all rule violations alleged by NFA against all parties.**
- **Amend its rulebook so that it may exercise jurisdiction over persons associated with members, whether such persons are associated with a member as employees or as independent contractors.**

## **VIII. DISPUTE RESOLUTION PROGRAM**

### **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 acceptable practices set forth in Appendix B to Part 38, an exchange is required to provide customer dispute resolution mechanisms that are fair, equitable, and available on a voluntary basis. Customers should have the opportunity to have their claims heard and decided by an objective and impartial decision maker. In addition, each party should have the right to counsel, adequate notice of claims presented against him or her, and an opportunity to be heard on all claims, defenses, and counterclaims. The process should provide for a prompt hearing, as well as prompt, written final settlement awards that are not subject to appeal within the exchange. The parties should also be notified of the fees and costs that may be assessed. 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 customer's claims or grievances.

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

CCFE and USFE customers are afforded voluntary arbitration of any disputes with Exchange members. Under the Exchanges' rules, customer-member arbitrations are conducted pursuant to NFA's Code of Arbitration ("Code").<sup>67</sup> The Code is incorporated into the respective exchange's rules by reference. With respect to HedgeStreet, customer-member arbitration is not relevant because the HedgeStreet is not intermediated.

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<sup>67</sup> CCFE Rules 802,803; USFE Rule 701.

Matters subject to arbitration include any dispute, claim, or controversy between a customer and a member in connection or related to exchange business. Under the NFA Code, arbitration is permitted only within two years of the act or transaction that is the subject of the controversy.<sup>68</sup>

Arbitration proceedings are initiated when the party desiring to submit a matter to arbitration (“claimant”) files an arbitration claim with the NFA. In the alternative, potential claimants may notify NFA, orally or in writing, of their intent to arbitrate, and thereby toll the statute of limitations.<sup>69</sup> Where an aggregate claim does not exceed \$50,000, NFA appoints one arbitrator, but a party may demand three arbitrators for claims between \$25,000 and \$50,000. If the aggregate claim exceeds \$50,000, NFA appoints three arbitrators. All arbitrators are appointed by the Secretary of NFA, and consist of individuals who are NFA members or connected with members. However, customers may request that the panel chairperson and at least one other arbitrator, or the sole arbitrator in a single-person panel, not be NFA members or connected with members.<sup>70</sup>

Arbitration proceedings are held at a time and place determined by NFA. Each party has the right to be represented by counsel.<sup>71</sup> Each party also has the right to present its claims, defenses, counterclaims, evidence and witnesses. Prior to hearing, parties may formally request relevant documents and information from other parties. Parties may examine witnesses

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<sup>68</sup> NFA Code of Arbitration ¶ 6035.

<sup>69</sup> NFA Code of Arbitration ¶ 6041.1.

<sup>70</sup> NFA must promptly notify the parties in writing of the name, business affiliation, and classification (member or non-member) of each arbitrator, and parties have the right to file specific written objections to particular arbitrators. Arbitrators have a continuing obligation to notify NFA of any circumstances likely to affect their impartiality, including bias, financial interest in the outcome of the arbitration, or any past or present relationship with the parties or their representatives. In addition, parties have a similar obligation to notify NFA of any such relationships with an arbitrator. The parties must be notified of any such notifications. NFA alone determines whether an arbitrator should be disqualified.

<sup>71</sup> NFA Code of Arbitration ¶ 6047.



appearing at hearing. The arbitrators, at the request of any party, may direct the appearance of any member, or any person employed by any member, who is not a party to the arbitration. They may also direct the production of any records in the possession or control of such persons.<sup>72</sup>

Arbitration panels must render a decision within 30 days from the date the record is closed. The decision must be signed, in writing, and reflect the panel's majority. The panel may award damages sought, and may assess interest, costs, and fees. Awards are final and there is no right of appeal, except that a party may, within 20 days, request a modification because of evident material miscalculation of figures, scope, or imperfections in form. Awards may be entered as a judgment in any court of competent jurisdiction.<sup>73</sup>

Any award granted to a claimant against a member or an employee of a member must be paid within 30 days after the member or employee is served with the award. Failure to satisfy an award is a violation of exchange rules and grounds for disciplinary action under exchange rules. In addition, the President of NFA may, on 30 days written notice, summarily suspend a Member for failure to comply with an award within 30 days of service.

There were no customer arbitrations at CCFE or USFE during the target period.

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

While USFE members are free to arbitrate any disputes that may arise between them, such arbitration is not mandatory and is not provided for in USFE's rulebook. CCFE and HedgeStreet's member-to-member arbitration procedures are substantively similar to those for customer arbitration. Member-to-member arbitrations are governed by CCFE Rule 801 and

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<sup>72</sup> See generally, NFA Code of Arbitration ¶¶ 6048 and ¶ 6053 for pre-hearing and hearing procedures.

<sup>73</sup> See generally NFA Code of Arbitration ¶ 6059 for awards and modifications.

HedgeStreet Rule 10.2. Arbitration panels for member-to-member disputes consist only of NFA members or persons connected with members.

Where the aggregate claim does not exceed \$100,000, NFA appoints one arbitrator, but a party may request a three-member panel if the amount is between \$50,000 and \$100,000. If the aggregate claim amount exceeds \$100,000, then three arbitrators are appointed.<sup>74</sup> NFA must notify the parties of each arbitrator's name, business affiliations, and other relevant information.

As with customer arbitrations, there is a two-year statute of limitations for member arbitrations. The statute of limitations is tolled once a Notice of Intent to Arbitrate is filed.<sup>75</sup> Parties in member-to-member arbitrations have the right to representation by counsel.<sup>76</sup> Each party also has the right to present its claims, defenses, counterclaims, evidence and witnesses. Arbitration panels must render their decisions within 30 days after the record is closed. As with customer arbitrations, awards are final, and there is no right of appeal except for specific circumstances. Awards must be honored within 30 days of service, or further disciplinary action may be taken.

There were no member arbitrations at CCFE or HedgeStreet during the target period.

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

The Division found that CCFE's, USFE's, and Hedge Street's rules all provide fair and equitable procedures for the resolution of customer and member disputes. Customers have the opportunity to have their claims heard by majority non-member panels. With respect to both customer and member arbitrations, all parties have the right to counsel. Parties also receive

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<sup>74</sup> NFA Code of Arbitration ¶ 6523.1.

<sup>75</sup> NFA Code of Arbitration ¶ 6535.1.

<sup>76</sup> NFA Code of Arbitration ¶ 6541.

adequate notice of the claims against them and have an opportunity to present their claims, defenses, counterclaims, evidence and witnesses. Arbitration panels must issue their decisions within 30 days and parties must comply with any awards within 30 days of service. All decisions are final, except for a limited right of appeal in special circumstances. Since there were no requests for arbitration filed during the target period at any of the exchanges, the Division was unable to evaluate the adequacy of the exchanges' dispute resolution programs.