

RULE ENFORCEMENT REVIEW OF THE CHICAGO BOARD OF TRADE



**Division of Market Oversight
August 25, 2005**

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RULE ENFORCEMENT REVIEW OF THE CHICAGO BOARD OF TRADE

I. INTRODUCTION

The Division of Market Oversight (“Division”) has completed a rule enforcement review of the audit trail, trade practice surveillance, disciplinary, and dispute resolution programs of the Chicago Board of Trade (“CBT” or “Exchange”) for compliance with related core principles under Section 5(d) of the Commodity Exchange Act (“Act”), as amended by the Commodity Futures Modernization Act of 2000 (“CFMA”), and Part 38 of the Commission’s regulations.¹ The review covers the period of October 1, 2003 to October 1, 2004 (“target period”).

The review focused on 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; 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; and Core Principle 13, *Dispute Resolution*, which relates to an exchange’s alternative dispute resolution

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

program for market participants. Appendix B to Part 38 provides acceptable practices for demonstrating compliance with these core principles.²

For purposes of this review, Division staff interviewed compliance officials and staff from the Exchange's Office of Investigations and Audits ("OIA"), and observed a demonstration of CBT's SMART and E-SMART electronic surveillance systems.³ The Division also reviewed numerous documents used by OIA in carrying out the Exchange's self-regulatory responsibilities. These documents included, among other things, the following:

- computer reports and other documentation used routinely for audit trail enforcement and trade practice surveillance;
- audit trail review and trade practice investigation files;
- trade practice investigation, floor surveillance, disciplinary, and arbitration logs;
- disciplinary case files;
- minutes of disciplinary committee and Board of Directors ("Board") meetings held during the target period; and
- compliance procedures manual and guidelines.

The Division provided the Exchange an opportunity to review and comment on a draft of this report on August 10, 2005. On August 16, 2005, Division staff conducted an exit conference with CBT officials to discuss the report's findings and recommendations.

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

³ A copy of the December 15, 2004 transcript of the interview can be found in Appendix 1.

II. SUMMARY OF FINDINGS AND RECOMMENDATIONS

A. Audit Trail

Findings

- CBT maintains an adequate audit trail program, which records trade data in a manner that enables CBT to identify customer and market abuses and provide evidence of rule violations.
- The Exchange maintains a complete electronic record of all orders entered and transactions executed on its electronic trading platform, e-cbot, including the time of order entry, trade matching, and any modification to an order. This record enables CBT to reconstruct electronic trading efficiently and effectively.
- The majority of futures orders for open outcry trades at CBT are now transmitted to the pit electronically and processed through the Exchange's new Denali trade processing system, which creates an electronic trade data record similar to that maintained for electronic trades.
- CBT also maintains a traditional paper audit trail for orders transmitted to the pit by flashed hand signals or physical delivery of order tickets, and monitors individual member and member firm compliance with recordkeeping rules through routine audit trail reviews which result in detection and sanctioning of recordkeeping violations.
- CBT has adequate procedures for safe storage of audit trail data. Data is backed up daily and stored at CBT's disaster recovery facility and a separate, offsite backup storage location. Electronic trading data is also replicated and stored at a facility of the London International Financial Futures Exchange ("LIFFE"), which operates the LIFFE CONNECT system that powers e-cbot.

The Division has no recommendations in this area.

B. Trade Practice Surveillance

Findings

- CBT maintains an adequate trade practice surveillance program. The Exchange's automated surveillance systems for both open outcry and electronic trading enable OIA investigators to conduct focused review of exception reports and create customized, ad hoc queries of all Exchange trade data in order to identify instances of possible trade practice violations.
- OIA monitors all trading activity at CBT through various types of investigations in a manner capable of detecting trading activity prohibited by Exchange rules.

Investigators also conduct a sufficient amount of floor surveillance of open outcry trading.

- During the target period, OIA closed 200 trade practice investigations. The Division found that the investigations were thorough and well-documented, and included appropriate, well-founded analyses. A number of complex investigations involved analysis of substantial amounts of data and extended periods of trading activity. OIA also completed investigations in a generally timely manner.

The Division has no recommendations in this area.

C. Disciplinary Program

Findings

- CBT maintains an adequate disciplinary program, which enables the Exchange to take effective disciplinary action when rule violations are suspected. CBT's rules ensure due process for disciplinary proceedings, and give the Exchange the authority to discipline, suspend, or terminate members or market participants found to have committed rule violations.
- During the target period, the Exchange took final disciplinary action in 34 cases. Eleven additional cases were before disciplinary committees at the conclusion of the target period. The Division found that the sanctions imposed in the 34 closed cases appear reasonable relative to the violations alleged and the evidence presented. The Exchange assessed \$499,130 in fines against 37 members, ordered \$188,426 in restitution paid by six members, suspended 22 members for a total of 495 trading days, permanently banned two members, suspended one member firm for a minimum of two years, and reprimanded two members, two member firms, and two member firm employees. CBT also completed disciplinary proceedings in a generally timely manner.

The Division has no recommendations in this area.

D. Dispute Resolution Program

Findings

- CBT maintains an adequate alternative dispute resolution program for market participants and exchange members. Exchange rules provide fair and equitable procedures for the resolution of customer and member disputes. In particular, customers have the opportunity to have their claims heard by arbitration panels where a majority of the arbitrators are not affiliated with CBT or any contract market.
- During the target period, 33 arbitrations were filed, including four customer arbitrations and 29 member-to-member arbitrations. Eighteen matters were decided,

nine were settled, four are pending, and two were withdrawn. A total of \$987,350.40 was awarded to claimants in 14 decided matters, including two awards totaling \$3,300 in two customer arbitrations. The arbitrations were conducted in conformance with the Exchange's arbitration rules and were completed in a timely manner.

The Division has no recommendations in this area.

III. COMPLIANCE STAFF

The Exchange's compliance staff is headed by a Vice President of OIA ("Vice President"), who has been with the Exchange for 16 years. The Vice President oversees OIA's Investigations, Regulatory Reporting, and Market Surveillance Departments.⁴

OIA's 30-person Investigations Department ("ID") is headed by a Managing Director, who has also been with OIA for 16 years. ID's supervisory staff includes two Senior Managers, who each have eight to 11 years of experience with OIA; a Manager with 15 years of experience; three supervisors with six to nine years of experience; and three assistant supervisors with six to seven years of experience. The Senior Managers and Manager are responsible for administration and oversight of ID programs and casework. Supervisors and Assistant Supervisors review the casework of staff investigators, and also conduct investigations and surveillance. ID has 20 staff investigators, including ten Senior Investigators and ten Investigators, who conduct investigations and surveillance. The experience of the investigators ranges from five years to less than one year with the Exchange. Four investigators also have previous experience at futures industry firms or in regulatory positions at other exchanges.

OIA's four-person Regulatory Reporting Department, which conducts routine audit trail reviews to ensure member compliance with recordkeeping requirements, is headed by a Senior

⁴ Because this review did not include the Exchange's market surveillance program, this report does not discuss the Market Surveillance Department. The Exchange's market surveillance program was reviewed by the Division in a Market Surveillance Rule Enforcement Review report dated July 25, 2001.

Manager, who has 15 years of experience at the Exchange. The Senior Manager supervises the work of two Assistant Supervisors and one Senior Analyst, who conduct computerized trading reviews and back office audits as part of the Exchange's audit trail review program.⁵

OIA is also assisted by two Exchange Compliance Counsels, who support OIA and the Exchange's disciplinary committees in connection with cases brought before those committees, and by two regulatory systems staff who interact with the Exchange's information technology group with respect to the computer technology used by OIA.

OIA is headed by a knowledgeable and experienced management team, and appears to have adequate staffing levels to monitor CBT markets. Notably, OIA maintains approximately the same staff size noted in the Division's trade practice Rule Enforcement Review report dated June 30, 2000, even though CBT's current target period volume of 542,188,568 contracts is more than double its volume of 233,528,558 contracts at the time of the 2000 review.⁶ Significantly, however, much of the increase has consisted of electronic trading, which has a comprehensive electronic audit trail that helps deter potential violations and eases the task of detecting them. OIA also attributes its ability to continue adequate trade practice surveillance of higher numbers of trades without large increases in staff size in part to the electronic tools CBT has developed for surveillance of both open outcry and electronic trading. These tools allow OIA to work more efficiently and avoid many of the time-consuming manual calculations formerly required in trade practice investigations.⁷

⁵ The reviews and audits are discussed below at pages 15-20.

⁶ The Division's last trade practice Rule Enforcement Review, dated February 19, 2002, was a follow-up review concerning issues raised in the 2000 Rule Enforcement Review.

⁷ CBT's electronic surveillance systems are discussed more fully below at pages 23-24.

IV. AUDIT TRAIL PROGRAM

Core Principle 10 – Trade Information:

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

Core Principle 17 – Recordkeeping:

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

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

Original source documents include unalterable, sequentially identified records on which trade execution information is originally recorded, whether 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. Progress Toward An All-Electronic Audit Trail

CBT now captures and retains the majority of its audit trail data by electronic means. One principal reason is the dramatic growth in electronic trading which has occurred at CBT over the past five years. Electronic trading on e-cbot, which was approximately 11% of CBT's total volume in 2000, accounted for approximately 58% of CBT's total volume during the target period, and had reached approximately 70% of total volume as of May 2005.⁸

CBT's audit trail is also increasingly electronic in nature because the Exchange has adopted new technology (discussed below) which creates an electronic record of open outcry trade data as orders are transmitted electronically to the pit and orders are accepted and trades recorded by floor traders on electronic devices. CBT is moving toward an eventual goal of a virtually all-electronic audit trail for open outcry as well as electronic trades. However, the Exchange also continues to maintain its traditional paper audit trail for those open outcry trades which are not yet recorded electronically.

⁸ Today, the majority of CBT's electronic trades involve financial futures products, while the bulk of its remaining open outcry trades involve agricultural products and financial options.

B. Electronic Audit Trail For Electronic Trades

CBT's electronic trading system, e-cbot, creates a comprehensive audit trail for electronic trades by automatically recording all keystrokes entered, the time of order entry and the time of execution for each matched trade. The information is maintained in two databases in the system: (1) an order database, which includes all information entered in connection with each order, and (2) a trade database, which includes all data concerning the two sides of each matched trade. As noted earlier, the e-cbot system is powered by the LIFFE CONNECT electronic trading platform operated by LIFFE.

The audit trail for each electronic order includes the order's price, quantity, buy or sell indicator, customer type indicator code, account identifier, and order type (e.g., limit, market, or good-till-cancelled). When applicable, orders may also include a give-up identifier, market maker identifier, or expiry date (for good-till-cancelled orders). All of this information must be entered before e-cbot will accept an order. Each order must also include the unique e-cbot identifier of the user entering the order. This information is recorded automatically, based on the user's login identification. The system also maintains an unalterable record of the time each order is entered. Although an order may be cancelled or changed, no order can be erased. The original order is always retained and the trading system records the login identification of the e-cbot user making changes or canceling the order. When two orders are matched by the algorithm, the system automatically records the time of the matched trade, to the nearest thousandth of a second.

From their desktop computers, OIA investigators have electronic access to all audit trail data on trade date plus one for e-cbot orders and trades during the previous 18 months. They can

also call up data covering the previous five years from the Exchange's computer archives whenever older data is needed.

C. Electronic Audit Trail For Open Outcry Orders

CBT also maintains an electronic audit trail for all open outcry orders transmitted to the floor through electronic order routing, which has become the predominant method by which orders reach the floor. During the target period, more than 80% of open outcry orders for agricultural futures—which comprise the largest portion of open outcry orders—and 55% percent of open outcry orders for financial and equity futures were transmitted to floor brokers in the pit in this manner.⁹

CBT floor brokers receive electronically-routed open outcry orders on laptop computer devices called Electronic Clerks ("ECs"). ECs enable floor brokers to organize their order decks automatically by price and order type; group orders at the same price and order type for faster and easier execution; endorse filled orders; and return trade confirmations to the originating order entry device.¹⁰ Orders can be transmitted directly to ECs through the Exchange's Application Programming Interface ("API"). They can also be transmitted to an EC by a floor desk clerk using a Comet laptop device provided by the Exchange, after being sent to the floor desk of a member firm via telephone or a proprietary order routing system.¹¹

⁹ At the time of the 2000 Rule Enforcement Review, only 30% of agricultural futures orders reached the floor via electronic means. By June 2005, the percentage of agricultural futures orders transmitted and recorded electronically had reached 94%.

¹⁰ The Exchange estimates that approximately 260 ECs were in use by floor brokers at the conclusion of the target period, with 160 being used to handle agricultural futures and options orders, and 100 being used for financial and equity futures and options orders.

¹¹ Comet enables floor staff to send futures and options orders to pre-designated floor brokers; transmit order tickets to the executing floor broker for endorsement; timestamp order tickets automatically; receive trade fill data from the floor broker's EC and forward fills to the firm's bookkeeping system for trade processing; and handle customer inquiries. Comet also allows members to pre-program quick-pick lists of customer account numbers to speed account number input and reduce possible errors, and it can also process single-firm give-up information. The Exchange estimates that 150 Comet workstations are currently being used to route orders from member firm booths to broker ECs in the Exchange's agricultural complex.

CBT locals can record their personal open outcry trades on CBT Handheld Trading Devices (“HHTs”), which are lightweight, wireless, handheld computers provided to locals by the Exchange and sometimes referred to as “electronic trading cards.”¹²

In January 2005, shortly after the end of the target period, CBT implemented its new Denali system for open outcry trade processing, which provides a near-real-time electronic trade matching, endorsement and confirmation system for open outcry orders processed through ECs or HHTs.¹³ CBT has adopted a goal of making its open outcry trading environment fully electronic by having all pit trades processed through Denali, and it is offering incentives and applying new data submission performance standards to floor brokers and locals in order to achieve that goal.¹⁴

The Denali system gives CBT an electronic audit trail for open outcry trades that are processed through the system. An unalterable record of the terms of each order routed electronically to an EC on the floor and the terms of each entry made to an EC by a floor broker

¹² As of the end of the target period, only a minority of locals were using HHTs. CBT estimates that 200 HHTs were being used by locals, and that 150 members were using HHTs to submit the majority of their transactions. As of July 2005, approximately 90% of single month futures traders in agricultural products were using HHTs to submit their trades (in the majority of cases after first recording them on paper trading cards).

¹³ Denali provides automatic or “straight through” processing for open outcry trades for which buy and sell side data match exactly. When, for example, a floor broker and a local make a trade by open outcry, the floor broker’s clerk inputs the broker’s buy order information, including quantity, price, and the opposite party’s acronym, into the broker’s EC. The local enters the same information on the sell side into his HHT. This buy and sell side data is immediately compared by the Denali server. If the buy and sell side data match, the system assigns a Deal ID and transmits the two sides of the trade to the Chicago Mercantile Exchange (“CME”) Clearing House, which clears all CBT trades, for clearing as a matched pair. At the same time, Denali also transmits the matched trade data back to the EC and HHT of the floor broker and local involved. This gives them continuously updated information concerning their positions. In instances where buy and sell side data do not match exactly, Denali immediately transmits notice of the resulting outtrade or discrepancy to the broker’s EC and the local’s HHT, thus allowing quicker error resolution.

¹⁴ Under CBT’s new data submission performance standards for open outcry trading, 90% of all open outcry trades must be submitted to clearing within 30 minutes, and surcharges will be phased in for member firms and traders who fail to comply. In addition, members must use electronic order routing or order endorsing for all agricultural product orders for 20 contracts or less. CBT has also adopted additional incentives designed to encourage HHT use by locals. The Exchange is charging reduced fees to locals who submit their trade data via an HHT, and is providing training on how to do so. It has also mandated that all single month futures traders in agricultural products must migrate to HHTs, and has established a 10-cent surcharge for agricultural product trades not submitted via HHTs.

or to an HHT by a local, including any changes entered, is retained in a Denali system database known as Echelon. The database also includes an automatically created record of the time an order is transmitted to an EC; the time an order is accepted by a floor broker; the time that any change to an order is entered; the time that a trade or order fill is recorded on an EC or HHT by a floor broker or local; and the time that buy and sell side data for a trade is matched by the Denali system. Times are recorded to the nearest one thousandth of a second. Denali thus should improve the precision, accuracy and reliability of CBT's audit trail data for open outcry trades.¹⁵ The electronic audit trail for open outcry orders and trades created by Denali is substantially similar to the audit trail retained by e-cbot with respect to electronic orders and trades, with the significant exception that, because pit trades are (by definition) executed by open outcry rather than by a computer algorithm, the execution times of open outcry trades are not recorded electronically.¹⁶

Denali also makes CBT's audit trail data for open outcry trades more readily available to OIA staff for surveillance purposes. The entire electronic audit trail for open outcry trades retained in the Echelon database is accessible to OIA through an electronic query tool. This allows OIA to obtain the information immediately, without having to first obtain paper order tickets or trading cards or EC or HHT documentation from clearing firms.¹⁷

¹⁵ As discussed below at pages 14-15, CBT's Computerized Trade Reconstruction system uses the various timing indicia available from the electronic or paper audit trail for each open outcry trade, along with time and sales information, to impute an execution time for the trade. Imputed trade times for the increasing majority of open outcry trades being processed through Denali are calculated using time indicia captured electronically, and this should result in more accurate imputation of increasing numbers of trade execution times.

¹⁶ Prices for all CBT open outcry trades continue to be included in the Exchange's Time and Sales report by the traditional method, with the floor broker or local calling out the price to Exchange staff.

¹⁷ Prior to implementation of the Denali system, audit trail information concerning open outcry trades processed through ECs and HHTs (as well as trades having a paper audit trail) was maintained by clearing firms. CBT retained an electronic record of transactions processed through ECs and HHTs for only two weeks, and the data was not readily accessible to investigators.

D. Paper Audit Trail For Open Outcry Orders

CBT maintains a traditional paper audit trail for orders transmitted to the pit by flashed hand signals or physical delivery of paper order tickets.¹⁸ When flashed orders are hand-signaled to a floor broker from the initiating firm's floor order desk, the terms of the order, the account identifier, and the order number must be recorded on a paper order ticket at the desk, unless this information is recorded electronically as the result of prompt transmission of the order by floor desk staff to the floor broker's EC via Comet as discussed earlier. Clerks can also hand-deliver paper order tickets to floor brokers.

When a customer order is executed, the floor brokers involved are required to record fill information on an order ticket if the order is not routed or recorded through an EC and thus recorded automatically. Trades executed for a member's personal account are recorded on sequenced trading cards, and trades made for other members on the floor are recorded on non-sequenced trading cards known as endorsement cards. All trade data must be recorded in non-erasable ink. The trade data required to be recorded includes the date, price, quantity, commodity, and contract month of the trade, the time bracket symbol of the time bracket during which the trade was executed, the executing member's name or symbol, the name of the member firm clearing the trade, and the identity of the opposite member and clearing firm. Options trades must also include the strike price, put or call indicator, and expiration month.

Order tickets must be timestamped immediately when received on the floor ("entry time") and when the fill is reported to the customer ("exit time"), and must contain an account identifier and an order number. Clearing firm staff collect order tickets and enter the data from them into the CME clearing system.

¹⁸ Orders can also be received by floor brokers over headsets, either from clerks at a floor order desk or directly from customers, but all such orders must also be recorded on paper order tickets if they are not also recorded electronically by the floor broker's EC after transmission via Comet.

Trading cards are single-sided and must contain a pre-printed sequence number and the floor member's trading symbol. All transactions on the card must be recorded in the order in which they were executed, and no more than six transactions may be recorded on a single card. A floor member may correct an error by crossing out erroneous information, but must do so without obliterating it. The floor member may not skip any lines when recording trades, and must cross out any unused lines before starting a new card. A new trading card must be used at the start of each 15-minute time bracket. All trading cards used during any 30-minute period must be timestamped and turned in for collection and timestamping by clearing firm staff, who keypunch the data into the CME clearing system, within 15 minutes of the end of the period.

E. Trade Timing For Open Outcry Trades

In order to comply with the Commission's one-minute trade timing requirement for open outcry trades, CBT's Computerized Trade Reconstruction ("CTR") system uses the various timing indicia from order tickets, trading cards, and electronic order routing data from ECs and HHTs, along with time and sales information, to impute execution times for all open outcry trades, including those routed or processed electronically. These timing indicia include entry and exit timestamps from customer order tickets, execution times recorded on endorsement cards for CTI-3 trades, the beginning and ending times of 15-minute time brackets, trading card sequence numbers, the sequence of trades on trading cards, and other required handwritten execution times, such as those for cross trades. From these data, the CTR system constructs a series of timing windows using relevant "start" and "end" times, and uses comparison of these windows to narrow the timeframe during which the trade could have taken place. Based on the narrowest timing window that can be constructed, the system then assigns an imputed execution time to the trade.

F. Enforcement Of Trade Recordation Requirements For Open Outcry Trades

OIA uses CTR execution times and the trade data collected from trading documents and electronic order routing data to reconstruct trading and conduct trade practice surveillance with respect to open outcry trades. Because the accuracy and efficacy of this process depends on proper recordation of trade data by floor members and accurate entry of such data into the clearing system by clearing members, OIA's Regulatory Reporting Department ("RRD") conducts two types of routine audit trail reviews to monitor compliance with Exchange recordkeeping rules. RRD monitors floor member compliance with trade recordation requirements through daily electronic review of recordkeeping exception reports concerning all open outcry trades, and reviews clearing member compliance with data entry standards through regular back office audits.

1. Review Of Recordkeeping Exception Reports

OIA's principal tool for monitoring floor member recordkeeping compliance for open outcry trades is its CTR Edit system. The system produces computerized recordkeeping exception reports, known as CTR Edit reports, that identify instances of 35 types of audit trail recordation and data entry errors.¹⁹ The system produces CTR Edit reports covering different time periods, including 15-day reports, covering either the first 15 days of each month or the remaining (approximately) 15 days of each month; 30-day or monthly reports; and 45 day reports, covering the previous one and one-half months.²⁰

¹⁹ The exceptions generally involve (a) bracket errors, where a floor member does not indicate a time bracket or reports an erroneous time bracket; (b) time of execution errors, where a required execution time is not recorded or submitted; (c) sequence errors, where the imputed time for a trade entered into the clearing system is out of chronological order with other trades recorded on the trading card, or where trading cards are used out of sequence; and (d) price errors, where the price recorded for a trade is not found in the Exchange's time and sales report for the relevant time period. A complete list of the exceptions is attached as Appendix 2.

²⁰ The system also produces daily CTR reports covering each trading day, which are used to give CBT members continuous feedback concerning their compliance with recordkeeping requirements and encourage prompt correction of recordkeeping errors. At the beginning of each trading day, each trader has access to a printout of the

RRD reviews the 15-day, 30-day, and 45-day CTR Edit reports as they are produced, to determine whether any traders have recordkeeping errors in more than 8% of their trades, or have failed to comply with collection requirements with respect to more than 20% of their order tickets or trading cards. Traders receive a reminder letter if they exceed these thresholds in a 15-day report, and a second reminder letter if they are cited again in the 30-day report. All traders cited in the 45-day report receive a warning letter stating that disciplinary action may be taken if the problem is not corrected within 30 days. RRD also calls or meets with each warning letter recipient concerning his or her recordkeeping problems.

If a trader who has received a warning letter fails to reduce his or her recordkeeping error percentage below the specified thresholds within the next 30 days, OIA refers the trader to the CTR Subcommittee for possible disciplinary action.²¹ Traders are referred for disciplinary action immediately (without a 30-day period for improvement) if they appear on the 45-day report more than once for the same recordkeeping violation type within a six-month period. The CTR Subcommittee, which is responsible for all CBT disciplinary actions involving recordkeeping violations, is made up of two members from the Floor Governors Committee (“FGC”) and two members from the Business Conduct Committee (“BCC”). Although there is a summary fine schedule for audit trail violations, the Subcommittee has discretion to modify fines in individual cases. The typical first time fine is \$500, although this may be reduced if the member produces evidence that he or she has rectified the problem. However, fines are not rescinded entirely unless their imposition is subsequently found to be based on an error, and all traders found in violation pay some fine.

trader’s CTR Edit report from the previous trading day. Traders are encouraged to review their reports and correct the noted recordkeeping errors immediately, contacting their clearing firms as necessary for this purpose.

²¹ The CBT disciplinary committees which hold hearings and issue sanctions for offenses other than recordkeeping violations are discussed below at pages 31-33.

Reviews of CTR Edit reports during the target period resulted in the issuance of 222 warning letters to 195 individual traders.²² Eighty traders were referred to the CTR Subcommittee for disciplinary action regarding recordkeeping violations. The Subcommittee assessed a total of 80 summary fines, which totaled \$63,800.²³ Final fines totaled \$43,775, and ranged in individual cases from \$500 to \$5,000.²⁴

RRD also reviews CTR Edit reports regarding member firm compliance with requirements concerning the timestamping of order tickets and trading cards.²⁵ If a 15-day or 30-day CTR Edit report shows that more than 10% of the trades cleared by the member firm involved timestamping errors, OIA issues a reminder letter and calls the firm concerning the problem. If CTR Edit report reviews disclose that a firm has repeated instances of timestamp violations above the allowable threshold and the problem is not promptly corrected, RRD initiates a non-scheduled back office audit of the firm, which includes review of the violations noted in the exception reports, as well as examination of timestamps on trading documents for additional trading days selected on a random basis.

²² The 195 traders who received warning letters constituted approximately 7% of the 2,644 traders who traded at CBT during the target period, and approximately 12 % of the 1,613 traders who traded actively (i.e., had approximately 100 or more trades per month) during the target period.

²³ Three fines were rescinded when evidence obtained after the fines were imposed established that the traders had in fact not committed the recordkeeping violations on which the fines were based. The evidence consisted of late-submitted clearing firm documents, which demonstrated that the 45-day edit report citations of the traders had resulted from data entry errors by clearing firm staff.

²⁴ After fine reductions granted, as discussed above, in cases where traders produced evidence that they had rectified the recordkeeping problems for which they had been cited, fines actually paid ranged from \$100 to \$3,500.

²⁵ At CBT, the timestamping of these documents is performed predominantly by firm staff, not by individual traders. The CTR Edit reports concerning timestamping note three types of exceptions: (1) instances where the document is not timestamped; (2) instances where a timestamp does not match the time bracket recorded on the document; and (3) instances of a mismatch between a timestamp and a trade execution time.

2. Back Office Audits

RRD conducts annual back office audits at each CBT clearing firm in order to monitor the accuracy of the order ticket and trading card data submitted to the clearing system by the firm. As noted earlier, the CTR Edit system uses this data to impute one-minute execution times to open outcry trades. Firms that fail the annual audit are re-audited six months later.

Audits begin with review of background information including the firm's procedures for monitoring keypunch and timestamping errors and trading card collection times; any deficiencies found in the previous back office audit of the firm; any disciplinary actions involving the firm since the last audit; and any timestamping deficiencies noted in CTR Edit reports.²⁶ Each audit also includes an on-site visit, during which RRD examines trade documents for 500-600 trades in the case of larger clearing firms and 100-150 trades in the case of smaller clearing firms. This typically results in review of trades selected from two trading days. The trades selected for review include all trades flagged as exceptions in CTR Edit reports, plus a randomly-selected sample of other trades. The analyst conducting the review compares the information on order tickets and trading cards with the firm's cleared trade reports, to assess the accuracy of the data being used for CTR purposes.

Firms fail the audit if they have keypunch errors on more than 8% of the trades examined, or have failed to comply with Exchange rules concerning trading card and order ticket collection in connection with more than 20% of the scrutinized trades. If a firm's recordkeeping errors exceed these thresholds, RRD notifies the member firm by letter of the violations found, and refers the firm to the CTR Subcommittee for possible disciplinary action, including assessment of fines. The amounts of such fines are set at the discretion of the Subcommittee.

²⁶ The Exchange regularly verifies the accuracy of timestamp machines on its trading floors. Each day, CBT staff check the accuracy of the master clock in each trading room, and spot check a sample of the timestamp machines on the trading floor.

During the target period, OIA conducted 86 back office audits at CBT's 75 clearing firms. Fifty-eight firms (77%) passed the regularly-scheduled audit, while 17 firms (23%) failed the initial audit and were reaudited six months later. The audits resulted in issuance of 39 reminder letters to 38 firms. Each of the 17 firms which failed the audit was referred to the CTR Subcommittee for disciplinary action. The Subcommittee assessed a total of \$23,400 in fines against these firms for recordkeeping violations.²⁷

Division staff reviewed 21 of the 86 back office audits, selected at random, and found that they were thorough and well-documented. Each audit file included an audit summary, copies of original source documents, spreadsheets and workpapers prepared by OIA staff detailing findings concerning each transaction reviewed, an audit report, copies of staff reminder letters where applicable, and records of fines assessed where applicable.

During back office audits, when RRD reviews trading cards to assess the accuracy of data submitted by the firm to the clearing house, it also examines each card reviewed for individual trader compliance with recordkeeping requirements which cannot be captured and reviewed through CTR Edit reports, including trading card collection deadlines, crossing out of unused lines, and use of non-erasable ink. If this examination reveals recordkeeping deficiencies, RRD requests additional documents for that trader and conducts an expanded review. If violations are found with respect to more than 5% of the trader's trades, or if the trader has missed collection deadlines with respect to more than 20% of his or her trades, RRD refers the trader to the CTR Subcommittee for disciplinary action.

²⁷ Fines assessed ranged from \$750 to \$2,500; the amounts paid ranged from \$500 to \$2,000. Nineteen fines were assessed, with two firms receiving second fines.

During the course of back office audits conducted during the target period, RRD reviewed the trading cards of 1,055 individual traders.²⁸ As the result of this trading card scrutiny, 11 traders were referred to the CTR Subcommittee for disciplinary action for failure to submit trading cards as required or to cross off unused lines. These traders were assessed summary fines totaling \$3,600 and ranging from \$100 to \$500.

G. Safe Storage Capability

CBT's audit trail data for open outcry trades is stored in a computer database at the Exchange's headquarters. This audit trail data is backed up on both a daily and weekly basis on computer tape cartridges, which are sent offsite each day or week, respectively, for storage at the data backup site employed by the Exchange, located approximately 30 to 40 miles from CBT's headquarters. Data is retained in storage for five years.²⁹

The Exchange's audit trail data for electronic trades is backed up at CBT's disaster recovery site, at CBT's separate offsite data backup facility, and at LIFFE, which as noted above operates the LIFFE CONNECT electronic trading platform that powers e-cbot.³⁰ CBT receives complete audit trail data for all e-cbot trades from LIFFE in real time, and also receives e-cbot trades and orders from LIFFE in the form of an end-of-day data file. On a nearly-real-time basis, CBT transmits the real time audit trail data to its remote disaster recovery site, where it is replicated on the site's backup e-cbot computer system. CBT loads the data from each day's end-of-day data file into a computer database at the Exchange, creates daily, weekly and monthly

²⁸ The 1055 traders whose order tickets and trading cards were scrutinized during back office audits constituted approximately 39% of the 2,644 traders who traded at CBT during the target period, and approximately 65% of the 1,613 traders who traded actively (i.e., had approximately 100 or more trades per month) during the target period.

²⁹ The Exchange has also begun creating monthly backups of the audit trail data on read-only optical disks, and it will begin sending these disks to the backup site for five-year storage and retention in the near future.

³⁰ On July 6, 2005, the name of the entity that operates the LIFFE CONNECT system that powers e-cbot, and at whose facility CBT's electronic trading data is stored, was changed to Atos Euronext Market Solutions Limited ("AEMS").

backups of the database on computer tape cartridges and daily backups on optical disks, and sends these backup copies to its offsite storage facility in the same manner as for open outcry data. LIFFE also functions as a repository of CBT backup data by retaining all e-cbot trade and order data for seven years in a computer database at an off-site storage facility.

CBT is in the process of retaining new disaster recovery and data backup services from a service provider that will maintain a data backup site for Exchange data approximately 750 miles from CBT's Chicago headquarters. Complete audit trail data for open outcry trades for the past five years will be transferred to the new service provider for storage. When the new arrangement is fully operational, CBT's audit trail data for e-cbot activity will be transmitted to the new site electronically on a daily basis over a secured network.

H. Conclusions and Recommendations

The Division found that CBT maintains an adequate audit trail program, which records trade data in a manner that enables CBT to identify customer and market abuses and provide evidence of rule violations. CBT now captures and retains the majority of its audit trail data by electronic means. Electronic trading on e-cbot now accounts for approximately 70% of CBT's total volume. The Exchange maintains a complete electronic record of all entries into e-cbot, including the time of order entry, modifications to orders, and trade matching. This record allows CBT staff to reconstruct e-cbot trading efficiently and effectively. The majority of orders for open outcry trades at CBT are now transmitted to the pit electronically and processed through the Exchange's new Denali trade processing system, which creates an electronic record of trade data similar to that maintained for electronic trades, and thus provides an improvement to the precision, accuracy and reliability of the Exchange's open outcry audit trail. CBT also maintains a traditional paper audit trail for orders transmitted to the pit by flashed hand signals or physical

delivery of order tickets, and monitors individual member and member firm compliance with recordkeeping rules through routine audit trail reviews which result in detection and sanctioning of recordkeeping violations. Finally, CBT has adequate procedures for safe storage of audit trail data. Data is backed up daily and stored at CBT's disaster recovery facility and a separate, offsite backup storage location, and electronic trading data is also replicated and stored at a LIFFE facility.

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

V. TRADE PRACTICE SURVEILLANCE PROGRAM

Core Principle 2 – Compliance with Rules:

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

Core Principle 12 – Protection of Market Participants:

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

Pursuant to Appendix B to Part 38 of the Commission's regulations, a contract market's trade practice surveillance program should have the arrangements, resources, and authority necessary to perform effective rule enforcement. The arrangements and resources attendant to the program should facilitate the direct supervision of the contract market, including analysis of relevant data. Trade practice surveillance programs can be carried out by the contract market itself or through delegation to a third party.

An acceptable program should have systems that maintain all data reflecting the details of each transaction executed on the contract market. In this regard, the program should include routine electronic analysis of 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.³¹

A. Routine Surveillance

OIA uses two automated surveillance systems as its principal tools for conducting trade practice investigations. It reviews open outcry trading using the Sophisticated Market Analysis Research Technology ("SMART") system, and reviews electronic trading using the similar Electronic Sophisticated Market Analysis Research Technology ("E-SMART") system.

Investigators use SMART and E-SMART to review transaction patterns and trading anomalies included in the exceptions databases of both programs, and determine which exceptions most merit further investigation. In conducting this analysis, investigators typically adjust the parameters of SMART's or E-SMART's pre-formatted exception reports, in order to focus on one or more members' individual trading characteristics, such as the markets and quantities they typically trade.

Investigators also routinely use SMART and E-SMART to craft customized, ad hoc queries of CBT trade data, in order to focus on particular markets, time frames, firms, participants, trade sequences, or other aspects of trading activity. For example, an ad hoc query might involve review of all trading activity during a major market move, identification of the traders who were selling the high and buying the low during that move, and focused review of

³¹ That aspect of Core Principle 2 that relates to the disciplining of members who violate Exchange rules is discussed below in Section VI. This section of the report addresses the Exchange's program for monitoring its markets for possible trading abuses and the investigation of any identified abuses.

their trades for possible violations. Another query might examine trading activity in a product traded both electronically and by open outcry, in order to search for frontrunning or other violations involving side-by-side trading. Still other queries might examine the trading of members in broker associations; scrutinize the activity of an individual trader, through simulation of the sequence of trades on individual trading cards, or review of profitable trades, out-of-sequence trades, or audit trail anomalies; or focus on trader relationships, characteristic trading practices or proximity of traders in the pit.

OIA monitors trading activity for possible trade practice violations by assigning investigators to several different types of investigations, which OIA calls investigation programs.³² The investigators assigned to each investigation type or program conduct regular reviews of exception reports and review trading through ad hoc queries in order to identify instances of possible trade practice violations that merit further investigation. OIA refers to this activity as “research.” During the research process, investigators may also obtain and analyze relevant documents, such as trading cards, account statements, or telephone tapes.

The different investigation types or programs to which OIA assigns its investigators include the following:

- In the Trade Practice Research (“TPR”) program, investigators review open outcry, electronic, and side-by-side trading activity for possible noncompetitive trading violations, such as prearranged trades, wash trades, taking the other side of a customer order, and preferential trading. This program is the primary source from which OIA generates cases. Investigators working in the TPR program are assigned to four-month rotations by product, with larger-volume products having their own rotations and smaller-volume products being combined into groups of two to three products each. During a rotation, assigned investigators conduct regular research into trading in the products in question. The TPR program also includes a quarterly review of block trades.

³² Sample excerpts from OIA procedures and reference manuals for each investigation type can be found in Appendix 3.

- In the Trading Ahead Review (“TAR”) program, investigators focus on possible instances of trading ahead of customer orders. In addition to cases resulting from investigators’ research activity, OIA initiates one TAR case each month in order to give further review to approximately 40 of the most suspicious instances of possible violations identified in the previous month’s trading ahead exception reports.
- In the Electronic Trading Internal (“ETI”) program, investigators supplement the reviews of electronic trading conducted in the TPR and TAR programs with additional reviews of each month’s electronic trades for possible instances of wash trading, trading against customer orders, or cross trade violations.
- In the Taking The Other Side Of an Order (“TOO”) program, investigators focus on potential assignment trade violations, conducting a monthly review of approximately 30 of the most suspicious assignment trades found on exception reports.³³

OIA also opens investigations and assigns investigators when complaints are received from customers, members, anonymous sources or other Exchange departments, and when referrals are received from Commission staff.³⁴

For products traded by open outcry, the investigators assigned to each product under the TPR investigation program are also responsible for conducting floor surveillance for that product. Investigators conduct daily floor surveillance at the open and the close for CBT’s four largest open outcry markets, including futures on Treasury Bonds, Ten-Year Notes, Soybeans, and Corn, and perform daily floor surveillance at either the open or the close for moderately active products, such as Treasury Bond options and Five-Year Note and Wheat futures. Less active products, such as Municipal Note futures, are observed at either the open or the close for two to three weeks out of each month. The investigators also conduct floor surveillance at contract expirations, and at random times during the trading session.³⁵

³³ CBT Rule 350.04, *Outtrades And Errors And Mishandling Of Orders*, allows a trader to assign the opposite side of a customer’s order to the trader’s error account if the customer’s order has been executed but cannot clear, or is unfilled or underfilled, due to an error, provided that the customer is made whole as if no error had occurred. These trades are referred to as “assignment trades.”

³⁴ Externally generated cases are logged and tracked as Inquiries (“INQs”) if they involve open outcry trading or as Electronic Trading External (“ETE”) cases if they involve electronic trading.

³⁵ Samples from OIA’s floor surveillance logs are attached as Appendix 4.

When an investigator detects a possible violation from either research or floor surveillance, the investigator meets with the manager or supervisor who oversees his or her work, in order to develop a strategy for pursuing the matter. The manager or supervisor then initiates an investigative file or “case,” which is recorded in the appropriate log and assigned a case number. During the investigation, initial or additional document requests are made, witnesses are interviewed, relevant trade data is reviewed and analyzed, and additional floor surveillance may be conducted. When appropriate, cases are expanded to include review of additional, related instances of possible violations.

After the assigned investigator and the manager or supervisor involved conclude that the issues in the case have been fully explored, OIA determines whether it has uncovered evidence that would support a charge of a rule violation in a proceeding before an Exchange disciplinary committee. In most cases, OIA’s Managing Director or other senior members of OIA staff participate in this decision along with the supervisor and investigator involved. When OIA determines that there is no reasonable basis to believe that a violation occurred and that the case should be closed administratively, a “memo to close” is prepared and included in the case file. When OIA determines that a case should be presented to a disciplinary committee, an investigation report is prepared and submitted to the Vice President of OIA for final approval. If the Vice President concurs that the case should be referred to a disciplinary committee for consideration of charges, the case is then converted into a separate disciplinary file, known as an Investigation (“INV”) file.

B. Adequacy of Investigations

The Exchange closed 200 trade practice investigations during the target period, including 133 opened prior to the target period and 67 opened during the target period.³⁶ The Exchange opened 158 additional investigations during the target period which remained open at its conclusion. The Exchange's routine surveillance programs were responsible for generating 138 of the closed investigations and 119 of the open investigations. The largest number of these Exchange-generated investigations, 97, involved possible noncompetitive trading violations such as prearranged or wash trading or taking the other side of a customer order. Review of possible instances of trading ahead of customer orders resulted in 59 investigations, while 57 investigations involved potential cross or wash trade violations on e-cbot, and 44 involved potential assignment trade violations. Sixty-one closed investigations and 38 open investigations resulted from complaints or tips from customers, member firms, or traders, while one closed investigation and one open investigation resulted from Division referrals.

To determine whether the Exchange is conducting adequate trade practice investigations, Division staff reviewed 100 of the 200 investigations closed during the target period. The investigations reviewed were drawn from investigations across all CBT markets, and included 25% or more of the closed investigations in each of the Exchange's investigative programs.³⁷

The Division found that OIA conducted thorough, well-documented investigations and made appropriate analyses. OIA generated substantial numbers of investigations in its routine

³⁶ As discussed in Section VI below, 33 of the 200 closed investigations were referred to Exchange disciplinary committees for consideration of charges.

³⁷ Division staff reviewed the following: 24 TPRs, including 13 referred to disciplinary committees; 15 TARs (no TARs were referred to committee); 11 TOOs, including two referred to committee; 21 ETIs, including 16 submitted for disciplinary action; and 27 externally generated investigations, including 14 referred to committee. The externally-generated investigations reviewed included 11 anonymous complaints and 16 member complaints. Staff also reviewed the one remaining disciplinary or INV file closed during the target period, which involved a bankruptcy proceeding.

surveillance programs, through both regular review of exception reports and appropriate construction of customized, ad hoc queries of CBT trade data. OIA also expanded the scope of investigations to review additional trading when warranted. Investigation files included, among other things, pertinent underlying trading documents, summaries of witness interviews, correspondence, computer reports, summaries of trading activity, and investigative activity logs. The files also contained the material needed for appropriate disciplinary committee deliberations, including closing memoranda describing the facts and setting forth OIA's conclusions and recommendations. The 33 investigations referred to disciplinary committees for disciplinary action and closed during the target period resulted in disciplinary sanctions involving substantial fines and denial of trading floor privileges for extended periods.³⁸

The Division found that OIA conducted a number of complex investigations involving analysis of a substantial amount of data over extended periods of time. For example, in one investigation commenced as a routine TPR into possible noncompetitive trading in soybean futures, OIA conducted statistical analysis of trading percentages among more than 50 traders in front-month soybean futures, and examined their trading patterns and outrades on the opens and closes over a period of six months.³⁹ OIA also listened to headset recordings of orders being placed. The investigation found that five members had engaged in noncompetitive trading, and resulted in fines totaling \$88,750 and 72 days of trading floor suspensions assessed against those members. In another investigation resulting from two independent, routine TPRs, OIA expanded its initial review once potential violations were discovered, and uncovered multiple instances where a member of a broker association had traded for his personal account while holding

³⁸ Investigations referred to disciplinary committees are discussed in more detail below at pages 36-40.

³⁹ Case number 02-INV-016.

executable customer orders which were later filled at worse prices.⁴⁰ This trader and other members of the broker association had also taken the other side of customer orders, and engaged in noncompetitive trading. OIA interviewed all of the traders involved, and reviewed documents including trading cards, order tickets, and time and sales quotations. The traders were assessed fines totaling \$35,000, required to make restitution in the amount of \$16,875, and suspended from the trading floor for a total of 30 days.

In cases where OIA decided to close files because they found no reasonable basis to believe a violation occurred, investigations were also thorough, and decisions to close files were appropriately documented and supported by proper analysis. For example, in one trading ahead investigation, OIA examined the 20 most suspicious exceptions in a particular month.⁴¹ It then pursued investigation of five instances of possible violations, after initial review of trading records eliminated 15 exceptions. When OIA found additional possible violations relating to one of these five exceptions, which required a broadened investigation, it opened a separate case file for that matter.⁴² Although the four remaining exceptions involved only single instances of possible trading ahead, OIA expanded its review to include three months of trading in each instance, and closed the investigation only after no additional instances of possible trading ahead were found.

C. Timeliness of Investigations

The Division also reviewed the 200 investigations closed during the target period for timeliness. OIA closed 158 of the 200 investigations, or 79%, in less than one year. Forty-two investigations, or 21%, remained open for more than one year, for periods ranging from 13 to 25

⁴⁰ Case number 04-INV-14.

⁴¹ Case number 03-TAR-14.

⁴² Case number 03-TAR-20.

months.⁴³ Of these longer investigations, 13 cases, or approximately 6%, were open for 18 months or more. Six of these 13 longest investigations were submitted to disciplinary committees for disciplinary action.

The Division examined eight of the 13 investigations which remained open for 18 months or more, including the six longest investigations submitted to disciplinary committees and two of the longest investigations closed without disciplinary proceedings. The Division found that the six investigations ending in disciplinary proceedings involved complex fact patterns, multiple document requests, large numbers of parties, extensive document and trade data analysis, or other significant reasons to extend the investigation. The investigatory phases of these matters were also extended by the time needed to prepare them for the disciplinary process. The two investigations closed without disciplinary proceedings both involved multiple interviews, expansion of the investigation to consider additional periods of trading, and extensive document and trade data examination.⁴⁴ Therefore, the Division believes the length of these investigations was justified, and is not concerned about the general timeliness of the Exchange's investigations.

D. Conclusions and Recommendations

The Division found that CBT maintains an adequate trade practice surveillance program. The Exchange's automated surveillance systems for both open outcry and electronic trading enable OIA investigators to conduct focused review of exception reports and create customized, ad hoc queries of all Exchange trade data in order to identify instances of possible trade practice violations. These tools increase the efficiency of the Exchange's trade practice investigation

⁴³ Cases open for more than one year included 14 of 45 closed TPR cases; one out of 34 closed TAR cases; 8 out of 32 closed ETI cases; four out of 27 closed TOO cases; 14 out of 54 closed INQs; and one out of eight closed ETEs.

⁴⁴ In one of these cases, 02-TPR-045, six months passed between submission of the closing memorandum and the official closing of the file. OIA informed the Division that this occurred due to a shift in staffing.

process. Most of the matters investigated during the target period were generated by the Exchange's automated surveillance systems. Investigators also conduct floor surveillance.

During the target period, OIA closed 200 trade practice investigations. Forty-four investigations were referred to disciplinary committees for consideration of charges. The Division found that the investigations were thorough and well-documented, and included appropriate analyses. In addition, OIA expanded the scope of investigations when warranted. A number of complex investigations involved analysis of substantial amounts of data and extended periods of trading activity. OIA also maintained adequate investigation timeliness during the target period.

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

VI. DISCIPLINARY PROGRAM

Core Principle 2 – Compliance With Rules:

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

Core Principle 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. Disciplinary Committees

CBT's principal disciplinary committees are the Floor Governors Committee ("FGC") and the Business Conduct Committee ("BCC").⁴⁵ The FGC handles matters involving potential

⁴⁵ As discussed above at pages 16-20, recordkeeping violations are adjudicated by the CTR Subcommittee, which is comprised of members of the FGC and BCC.

trade practice violations in both electronic and open outcry markets, while the BCC handles matters involving market surveillance, back office operations, and general business conduct.⁴⁶

The FGC consists of seven Exchange members, and the BCC consists of eight Exchange members.⁴⁷ Each committee's members, including its chairman and vice-chairman, are appointed by the Chairman of the Exchange's Board of Directors with the approval of the Board.⁴⁸ Committee members serve staggered terms ranging from one to three years. Each member must take an oath to protect the confidentiality of information acquired in his or her official capacity.

The Exchange's Hearing Committee ("HC") conducts adjudicative hearings and has authority to issue sanctions in contested disciplinary matters where major sanctions, as defined in Exchange rules, may be imposed.⁴⁹ Hearings in contested matters potentially involving only minor sanctions are conducted by the FGC or BCC. The HC consists of up to 21 members of the Exchange appointed each year by the Chairman of the Board of Directors with the Board's approval. All HC members must previously have served on the Board, the FGC, the BCC, the Financial Compliance Committee, or the Arbitration Committee; however, they may not serve on

⁴⁶ As provided in CBT Rule 543.00(d), the function of the FGC is to assure that the trading practices and conduct of members and member firms, their employees, and other persons with trading privileges are in compliance with CBT's rules and regulations. According to CBT Rule 542.00(f), the primary function of the BCC is "to provide for the prevention of manipulation of prices and cornering of any commodity on the Exchange." CBT Rule 542(f) also gives the BCC jurisdiction over matters involving the business conduct of members, member firms, other persons with trading privileges, guaranteed introducing brokers, and their employees.

⁴⁷ Each committee may include both full members of the Exchange, whose memberships permit them to trade in any CBT market, and associate members of the Exchange, whose memberships permit them to trade only in CBT's government instruments, index debt and energy, and commodity options markets. The FGC must include at least two associate members, while the BCC may include one associate member.

⁴⁸ Directors and officers of the Exchange may not serve on the FGC.

⁴⁹ Under the provisions of CBT Rules 542.00(f) and 543.00(d), if the FGC or BCC determine preliminarily when issuing charges that the sanctions appropriate to the alleged offense exceed a fine of \$5,000 per violation or suspension of trading for five days per violation, hearings are held before the HC. Hearings are held before the FGC or BCC in matters where the committee determines preliminarily that the appropriate sanctions do not exceed these thresholds.

these committees or on the Board concurrently. Each HC member must take an oath to preserve the confidentiality of information acquired in his or her official capacity. Individual disciplinary cases are heard by seven-member panels of the HC.

CBT's Appellate Committee ("AC") hears appeals of decisions of the HC, FGC or BCC in contested disciplinary proceedings. AC decisions may be reviewed by the Board of Directors. The AC consists of five Exchange members who are or have been elected officers of the Exchange but are not currently members of a standing disciplinary committee, including at least one current Exchange officer. AC members are appointed by the Chairman of the Board of Directors with the approval of the Board. Each AC member must take an oath to preserve the confidentiality of information acquired in his or her capacity as an AC member.

B. Disciplinary Procedures

In disciplinary cases before either the FGC or the BCC, proceedings commence when OIA presents a written investigation report ("IR") to the committee, which must review it promptly. The committee may determine that additional investigation or evidence is needed and return the matter to OIA for further development. Within 30 days of receiving a completed IR, the committee must determine whether a reasonable basis exists for finding that Exchange rules have been violated, and either close the matter or issue charges accordingly. Determinations that a reasonable basis does not exist must be in writing and contain a brief explanatory statement.⁵⁰

Charges against a respondent must state the committee's preliminary findings of fact on which the charges are based; list the Exchange rules alleged to have been violated; notify the respondent of his or her right to request a hearing and right to counsel; and state the date by

⁵⁰ In such cases, the committee may also issue a reminder letter to those involved concerning their responsibilities under Exchange rules.

which a hearing must be requested. A respondent who elects to answer the charges must file a written, signed answer within five business days after the charges are served.

Charges must also include a preliminary determination by the committee of the sanctions appropriate to the charged offense. These sanctions may be imposed if the respondent does not contest the charges, or they may form the basis of settlement negotiations between the respondent and the committee.

Settlements are possible at various stages of the disciplinary process. Respondents may submit written settlement offers to the BCC or the FGC, as appropriate, or to the HC. The committee that issued charges has sole authority to consider settlement offers prior to commencement of a hearing before the HC. Once the HC has begun hearing evidence, it alone has settlement authority. A committee considering a settlement offer must allow OIA to present its views of the proposed settlement before determining how to deal with the offer. Committees may accept a settlement offer as submitted (including offers where the respondent neither admits nor denies liability), negotiate alternate terms, or reject the offer entirely. If an offer is rejected, the respondent may submit other offers. Offers of settlement do not prejudice the respondent in later proceedings.

Hearings concerning contested charges must be held promptly, after reasonable notice to the respondent. As noted above, hearings concerning charges which involve preliminarily-determined sanctions exceeding fines of \$5,000 or suspensions of trading privileges for five days are held by the HC, while charges involving preliminary-determined sanctions at or below these thresholds are heard by the FGC or BCC. No committee member may hear a matter in which he or any person or firm with which he is affiliated has a financial, personal, or other direct interest.

Prior to the hearing, the respondent is permitted to examine all evidence in OIA's possession, including witness statements. At least ten days before the hearing, the respondent must give OIA a list of the witnesses the respondent will present, and give OIA copies of or access to all books, records, documents and other tangible evidence the respondent will present.

Hearings are held with a court reporter present, and the respondent and all witnesses must be sworn in. However, the proceedings need not be governed by formal rules of evidence. The respondent is entitled to appear personally, to be represented by counsel, to present evidence, and to call and cross-examine witnesses. Persons within the jurisdiction of the Exchange who are called as witnesses must appear or present evidence, as required. Committee members may question both OIA's and respondent's witnesses. Both sides may make opening and closing statements.

After completion of the hearing, the committee must determine whether the respondent is guilty of the offenses charged. A decision must be rendered in writing within 30 days of the hearing, unless the complexity of the case or special circumstances require otherwise. Decisions are made by majority vote and based on the weight of the evidence contained in the record. A decision must be served on the respondent, and must include a summary of the charges, the answer, if any, and the evidence produced at the hearing; a statement of findings and conclusions concerning each charge, including the specific rules which the respondent was found to have violated; a declaration of the penalties imposed and their effective date; and notice of the right to appeal.

Appeals to the AC (or ultimately to the Board) from decisions issued by the HC, FGC, or BCC after a hearing must be filed within ten days. If no appeal is filed, the decision becomes final on the date indicated in the decision. If an appeal is filed, both the respondent and OIA

may file written briefs and appear before the AC. New evidence or legal arguments are not permitted, and the AC may reverse the decision or reduce the sanctions only upon finding that the decision was “clearly erroneous.” Appellate decisions, whether by committee or by the Board, must be rendered within 30 days of the appellate hearing, unless the complexity of the case or other special circumstances require otherwise. Decisions by the Board are final and conclusive. Within 30 days after a disciplinary action becomes final, the Exchange must provide a written notice of such action to the respondent. A copy of the notice is posted on the trading floor and made available to the National Futures Association and to the Commission.

C. Adequacy of Sanctions

During the target period, the FGC, BCC, and Hearing Committee closed 34 disciplinary cases, including 22 of the 33 cases sent to a committee during the target period and all of the 12 cases pending before a committee at the beginning of the target period. Thirty of the 34 closed cases were brought before the FGC, while four were brought before the BCC. Eleven of the 33 disciplinary cases that were sent to a committee during the target period remained open at its conclusion, all before the FGC. To determine whether the Exchange’s disciplinary process is imposing adequate sanctions on violators of Exchange rules, the Division reviewed all 34 closed disciplinary cases.

The Division found that the sanctions imposed by Exchange disciplinary committees during the target period appear reasonable relative to the violations alleged and the evidence presented. In the 34 closed cases, through three hearings before the HC and 48 settlement agreements, the Exchange assessed a total of \$499,130 in fines against 37 members, ordered \$188,426 in restitution paid by six members, suspended 22 members for a total of 495 trading

days, and issued reprimands against two members, two member firms and two firm employees.⁵¹ The Exchange banned one member permanently for misallocation of customer trades, and banned another permanently for misappropriation of funds, while also suspending the firm for which that member worked for a minimum of two years for failure to supervise and ensure compliance with Exchange rules.⁵² In addition, one clerk was suspended for 20 years. One case was closed by the FGC after a determination that there was insufficient evidence to issue charges. Based on its review, the Division is satisfied that closure of this case without charges was appropriate.⁵³

The substantive trade practice violations charged most frequently in the 34 closed cases included non-competitive trading (11 cases), pre-execution communications (six cases), and wash trading (five cases). In the aggregate, non-competitive trading was the most heavily-sanctioned violation, drawing \$159,000 in fines, \$20,625 in restitution, and 105 days of suspension imposed upon 18 members. The Exchange also levied \$215,000 in fines against six member firms in cases involving pre-execution communications.

One example of imposition of adequate sanctions in the 11 closed cases involving non-competitive trading is found in a case where two respondents associated with the same member firm were charged with noncompetitive execution of two large spread orders in the Treasury Bond pit opposite each other.⁵⁴ The charges were supported by headset recording evidence of

⁵¹ Additional sanctions including fines totaling \$85,250 and suspensions totaling 72 days were imposed on four of the five respondents in case number 02-INV-16. However, those sanctions and that disciplinary case are not included in the totals given above, because those four respondents settled prior to the target period. The fifth respondent settled his portion of 02-INV-16 during the target period, in conjunction with settlement of a separate disciplinary case in which he was the respondent. Case number 02-INV-16 is discussed above at page 28.

⁵² Both permanent bans were followed by statutory disqualifications initiated by the Commission's Division of Enforcement.

⁵³ All ordered restitution and \$497,030 of the \$499,130 in assessed fines were paid in a timely fashion. The Exchange is following up on payment of the remaining \$2,100 in fines still owed by two members.

⁵⁴ Case 2003-INV-22.

prearrangement of the trades, and witness testimony that the respondents did not present the transactions to the pit. The respondents admitted prior knowledge of the orders on both sides of the transactions, but claimed that one respondent had presented bids to the pit, and the other had waited an appropriate amount of time before responding. Nevertheless, in a settlement agreement the FGC fined one respondent \$20,000 and the other \$15,000.⁵⁵

During the target period, the Exchange moved aggressively to enforce its rules concerning cross trades and pre-execution communications on e-cbot. The rules barred firms from trading against a customer order on e-cbot unless the customer order was first exposed to the market for a minimum of five seconds for futures contracts and 15 seconds for futures spreads and options contracts. The rules also barred pre-execution communications concerning the crossing of two customer or proprietary orders, unless the cross trade was preceded by entry of a cross request on e-cbot and a delay of no less and no more than a specified number of seconds.⁵⁶ The sanctions imposed by the Exchange in this area also appear reasonable. In the six disciplinary cases brought for violations of these rules and closed during the target period, the Exchange levied a total of \$215,000 in fines against six member firms, ranging from \$75,000 to \$20,000. For example, in one such case the charged firm had failed to issue a cross request for cross trades involving pre-execution communications in 25 instances over a seven month period, and had delayed the cross trade for an average of only 1.01 seconds in the case of futures orders

⁵⁵ The disciplinary case was closed within four months of initiation of the investigation by OIA.

⁵⁶ At the beginning of the target period, CBOT Rule 9B.16(b) allowed pre-execution communications concerning the crossing of customer or proprietary orders on e-cbot if the cross trade was preceded by a cross request and a delay of between five and 35 seconds in the case of futures contracts or between 15 and 75 seconds in the case of options contracts. In February 2004, during the target period, the Exchange amended this rule to require a delay of between 15 and 45 seconds for futures contracts and 30 to 90 seconds for options contracts. In September 2004, near the end of the target period, the Exchange again amended the rule, and prohibited all pre-execution communications concerning the crossing of customer or proprietary orders on e-cbot.

and 2.11 seconds in the case of options orders.⁵⁷ In 17 other instances where the firm had entered a cross request, it had then executed a cross trade for a quantity greater than the quantity specified in the cross request. The FGC accepted a settlement agreement which included a \$30,000 fine against the firm.

Another instance of notable sanctions imposed via settlement involved trading ahead of customer orders by a floor broker.⁵⁸ The respondent was a salaried “roving broker” for a member firm who executed customer orders in agricultural pits in addition to trading for himself. He was charged with standing near his firm’s desks to overhear customer orders and then running into the relevant pit to trade ahead for his personal account. He allegedly profited by more than \$13,900 through personal trades of unusual size or profitability, some in contracts in which he was not otherwise active at the time, entered immediately before large orders received by his firm. The respondent settled with the FGC by agreeing to a \$30,000 fine and a 30-day suspension.⁵⁹

D. Timeliness of Disciplinary Process

The Division is satisfied that the disciplinary cases closed during the target period were handled in a timely manner. Of the 34 closed cases, 31 were closed by the disciplinary committees within six months following their referral by OIA, and half of these were resolved within three months. Of the remaining three cases, one took approximately six and a half months to resolve, one took approximately 12 months to resolve, and one took approximately 18 months

⁵⁷ Case number 2004-INV-9.

⁵⁸ Case number 2003-INV-23. The alleged violations included CBOT Rules 500.00 (Inequitable Proceedings) and 504.00 (Acts Detrimental to the Welfare of the Association).

⁵⁹ The Division notes that the case was handled expeditiously, and closed within three months of the time it was presented to the committee by OIA.

to resolve. This last case involved six different respondents and a hearing. The disciplinary committees were typically prompt in reviewing cases after receiving them from OIA.

E. Conclusions and Recommendations

During the target period, the Exchange took final disciplinary action in 34 cases, which involved 48 settlement agreements and three hearings before the HC. The sanctions imposed in these cases appear reasonable relative to the violations alleged and the evidence presented. The Exchange assessed \$499,130 in fines against 37 members, ordered \$188,426 in restitution paid by six members, and suspended 22 members for a total of 495 days. In addition, the Exchange permanently banned two members, and suspended one member firm for a minimum of two years. It also issued reprimands against two members, two member firms, and two member firm employees.

Approximately one-third of the disciplinary cases closed during the target period involved non-competitive trading, primarily on the floor, and these resulted in \$159,000 in fines, \$20,625 in restitution, and 105 days of suspension imposed upon 18 members. Violation of the Exchange's pre-execution communication rules also resulted in numerous disciplinary cases and fines against six member firms totaling \$215,000. Other notable sanctions during the target period included a 20-year suspension imposed upon a clerk for improper trading; a \$30,000 fine and 30-day suspension against a floor broker for trading ahead of customer orders; and a \$75,000 fine against a member firm in a case involving improper pre-execution communications. Finally, almost half of the disciplinary cases closed during the target period were closed in three months or less, and 31 of 34 were closed in six months or less.

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

VII. 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, parties should have the right to counsel and be provided with adequate notice of claims presented against them 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 awards that are not subject to appeal within the exchange. The parties also should 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 customers' claims or grievances.

A. Customer Arbitration

Exchange customers are afforded voluntary dispute resolution through procedures set forth in Exchange rules.⁶⁰ Matters subject to arbitration include any claims or grievances between customers and members, member firms, and their employees that arise from transactions on or subject to the rules of the Exchange. Customers may compel members to arbitrate a dispute, but members may not compel customers. Customer claims must be filed within one year of the transaction giving rise to the claim or controversy.

⁶⁰ CBT Rules 600.00 through 640.05.

Arbitration procedures are initiated when the party desiring to arbitrate (“claimant”) presents the Administrator of CBT’s arbitration program with a Statement of Claim (“Statement”), an Arbitration Submission Agreement, and the appropriate filing fee.⁶¹ The Statement should include “all information necessary to reasonably inform the other party of the nature of the claim and the transactions involved.”⁶² The Arbitration Submission Agreement requires information such as the name of the respondent and the amount of the claim. Filing fees are \$150 for claims under \$2,500 and \$350 for claims of \$2,500 or more. Additional fees may apply for stenographic services, transcripts, unusually long hearings, or hearing panels including non-members of the Exchange (“unassociated” arbitrators) by the request of the customer.⁶³

A copy of the claimant’s Statement must be provided promptly to the respondent, who then has 10 business days to file an answer and any counterclaims. If the respondent fails to respond, he or she will be deemed to have denied the claim and waived any counterclaims. However, the Administrator may, at his discretion, extend the filing period for the respondent. If counterclaims are asserted, then the claimant must be given an equal opportunity to respond. Counterclaims must arise from the same transaction or occurrence as the claim, and may be asserted as a matter of right. Counterclaims not arising from the same transaction or occurrence may be arbitrated only with the customer’s written consent.

Customers may choose to have their disputes arbitrated by a panel consisting solely of Exchange members or one consisting of both members and unassociated arbitrators (“mixed

⁶¹ The Administrator is appointed by the President of the Exchange and assists the Arbitration Committee in the performance of its work, including receiving pleadings, selecting non-members to serve on hearing panels, scheduling and giving notice of hearings, maintaining books and records, etc. Exchange staff noted that arbitration proceedings often begin with customers or members contacting the Administrator and requesting information on the arbitration program. The Administrator advises the caller of his or her options, explains the process and fees, and provides an arbitration packet containing the documents noted here.

⁶² Instruction Sheet for Customers Claims and Grievances and CBT Rule 630.01.

⁶³ Fees for unassociated arbitrators, are paid by member respondents, regardless of the outcome of the arbitration, unless the arbitrators determine that the customer claimant acted in bad faith in initiating the arbitration proceeding.

panel”).⁶⁴ In either case, the panel will consist of five persons, but mixed panels will have a majority of unassociated persons. Member panels must include at least one of each of the following Exchange groups: floor traders, floor brokers, brokerage firms, and commercials. Member panelists for individual hearings are selected from among the members of the Exchange’s Arbitration Committee, which is composed of 28 members of the Exchange appointed by the Chairman of the Board of Directors with the approval of the Board. The 28 members, who serve two-year terms, must include seven members from each of the four Exchange groups listed above. Members of the Arbitration Committee may not serve concurrently on the Board or any standing disciplinary committee. Unassociated arbitrators are selected by the Administrator from a list of available persons maintained by him.

Arbitration hearings must take place in Chicago, Illinois, at a date set by the Administrator. The parties are given at least five business days advance notice of the exact time and place. All parties have the right to representation by counsel. Parties are permitted to make opening and closing statements, present witnesses and evidence, and cross-examine witnesses. However, formal rules of evidence do not apply, and arbitrators may allow stipulations and other such procedures to simplify the issues and expedite the hearing. All testimony is given under oath. If the total value of all claims and counterclaims is less than \$2,500, the matter will be decided based on written submissions only, unless the arbitrators request otherwise.

Decisions of the panel of arbitrators are made by majority vote, and must be in writing and signed by the arbitrators. In cases involving customer harm, punitive or exemplary damages up to two times the actual damages may be assessed if a floor broker acted willfully and intentionally in bringing about the customer’s losses. All arbitration decisions are final within

⁶⁴ For purposes of customer-member arbitrations, unassociated arbitrators may not be members of, associated with members of, employees of, or otherwise associated with the Exchange or any other contract market.

the Exchange, except that the arbitrators may make any necessary corrections or modifications. Arbitration decisions are filed with the Administrator, who then delivers copies to the parties. Failure to comply with an order or award of the panel within 30 days of notice is deemed a violation of Exchange rules.

B. Member-to-Member Arbitration

The Exchange's member-to-member arbitration procedures are similar to those for customer arbitration. However, while customer arbitrations are voluntary, arbitration is mandatory in member-to-member disputes, so long as the controversy arises from Exchange business. In addition, while the statute of limitations for customer disputes is one year, members may arbitrate a controversy up to two years from the date that the member knew or should have known of the dispute. Finally, disputes between members are heard by five-person member panels, as described above, and not by mixed arbitration panels.

C. Arbitrations During the Target Period

Thirty-three arbitrations were filed during the target period, including 29 member-to-member arbitrations and four customer arbitrations. Eighteen matters were decided, nine were settled, four are pending, and two were withdrawn. Of the decided matters, 14 favored the claimant, and resulted in \$987,350.40 in awards, including one award of \$851,667.57 in a matter with a parallel disciplinary case. In four instances, the arbitration panel found that there was no cause to grant an award. Of the four customer arbitrations, two resulted in total awards of \$3,300, and two were pending at the close of the target period. The Division found that the arbitrations were conducted in conformance with the Exchange's arbitration rules and were completed in a timely manner.

D. Conclusions and Recommendations

The Division found that the Exchange's arbitration rules provide fair and equitable procedures for the resolution of customer and member disputes. In particular, customers have the opportunity to have their claims heard by panels where a majority of the arbitrators are not members of the Exchange or affiliated with any contract market. Parties have the right to counsel. They also receive adequate notice of the claims against them, and have an opportunity to present their claims, defense, and counterclaims, as well as witnesses and evidence. In addition, the Exchange's arbitration rules provide for a prompt process and for final, written decisions that are not subject to appeal within the Exchange.

During the target period, 33 arbitrations were filed, including four customer arbitrations and 29 member-to-member arbitrations. Eighteen matters were decided, nine were settled, four are pending, and two were withdrawn. Awards to claimants in decided matters totaled \$987,350.40. The arbitrations were conducted in conformance with the Exchange's arbitration rules and were completed in a timely manner.

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