

RULE ENFORCEMENT REVIEW OF THE CHICAGO MERCANTILE EXCHANGE



Division of Market Oversight

October 27, 2006

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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 Mercantile Exchange (“CME” 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, 2004 to October 1, 2005 (“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 program for market participants. Appendix B to Part 38 provides acceptable practices for demonstrating compliance with these core principles.²

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 or core principles. The Division’s analyses, conclusions, and recommendations are based, in large part, upon the Division’s evaluation of a sample of investigation and disciplinary case files, and other exchange documents. This evaluation process, in some instances, identifies specific deficiencies in particular exchange investigations or methods but is not designed to uncover all instances in which an exchange does not address effectively all exchange rule violations or other deficiencies. Neither is such a review intended to go beyond the quality of the exchange’s self-regulatory systems to include direct surveillance of the market, although some direct testing is performed as a measure of quality control.

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

For purposes of this review, Division staff interviewed compliance officials and staff from the Exchange's Market Regulation Department ("Market Regulation").³ The Division also reviewed numerous documents used by Market Regulation 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, Board of Directors ("Board"), and Market Regulation Oversight Committee meetings held during the target period; and
- compliance procedures manuals and guidelines.

The Division provided the Exchange an opportunity to review and comment on a draft of this report on October 2, 2006. On October 11, 2006, Division staff conducted an exit conference with CME officials to discuss the report's findings and recommendations.

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 transcript of the interview, which took place on November 3, 2005, can be found in Appendix 1.

II. SUMMARY OF FINDINGS AND RECOMMENDATIONS

A. Audit Trail

Findings

- CME maintains an adequate audit trail program, which records trade data in a manner that enables CME to identify customer and market abuses and provide evidence of rule violations.
- For CME Globex[®], CME's electronic trading platform, the Exchange maintains a complete electronic record of all orders entered and transactions executed, including all messages entered into CME Globex, the terms and time of entry for each order, all order modifications, and all matched trades. This record enables CME to reconstruct electronic trading efficiently and effectively.
- For open outcry trading, CME maintains a traditional audit trail for all orders transmitted to the pit by flashed hand signals, physical delivery of order tickets, or electronic order routing. This record enables CME to reconstruct open outcry trading efficiently and effectively.
- CME monitors individual member and member firm compliance with recordkeeping rules through routine audit trail reviews which result in detection and sanctioning of recordkeeping violations. These audits now include regular review of compliance with CME Globex audit trail requirements.
- CME has adequate procedures for safe storage of audit trail data. Data is backed up daily and stored at an offsite backup storage location. CME Globex audit trail data and clearing data for both CME Globex and open outcry trades is also replicated in real time at CME's separate Remote Data Center.

The Division has no recommendations in this area.

B. Trade Practice Surveillance

Findings

- CME maintains an adequate trade practice surveillance program. The Exchange's automated surveillance systems for both electronic and open outcry trading enable Market Regulation investigators to conduct focused reviews of exception reports and create customized, ad hoc queries of all Exchange trade data in order to identify instances of possible trade practice violations. Since the Division's previous Rule Enforcement Review in 2002 ("2002 Review"), Market Regulation has further refined its automated surveillance systems and developed a new tool, RAPID, which allows Market Regulation to conduct real-time surveillance of CME Globex orders and trading.

- Market Regulation monitors all CME trading activity through a combination of visual, video, and automated computer surveillance, and conducts various types of investigations in a manner capable of detecting trading activity prohibited by Exchange rules.
- During the target period, Market Regulation closed 172 investigations, including 27 investigations involving electronic trading and 145 investigations involving open outcry trading. 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. Market Regulation also completed investigations in a generally timely manner.

The Division has no recommendations in this area.

C. Disciplinary Program

Findings

- CME maintains an adequate disciplinary program, which enables the Exchange to take effective disciplinary action when rule violations are suspected. CME'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 30 cases. The Division found that the sanctions imposed in these cases appear reasonable relative to the violations alleged and the evidence presented. The Exchange assessed \$1,704,500 in fines against 33 individuals and four firms, ordered \$4,612.50 in restitution to customers and \$386,547.46 in restitution to a clearing firm, suspended 33 members for a total of 458 days, and ordered two members not to fill customer orders for a total of 180 days. The Exchange also imposed permanent bars on membership against two members, one guilty of noncompetitive trading and the other of fictitious trading, fraud and dishonest conduct. CME completed disciplinary proceedings in a generally timely manner.

The Division has no recommendations in this area.

D. Dispute Resolution Program

Findings

- CME maintains an adequate alternative dispute resolution program for market participants and exchange members. Exchange 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 arbitration panels where a majority of the arbitrators are not affiliated with CME or any contract market.

- During the target period, 36 arbitrations were closed, including 14 customer arbitrations and 22 member-to-member arbitrations. Sixteen matters were decided, 18 were settled or withdrawn by the parties, and two were determined to involve non-arbitrable claims. Awards to claimants in decided matters totaled \$52,140.07. 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 AND MARKET REGULATION OVERSIGHT COMMITTEE

A. Market Regulation Department

CME's 57-person Market Regulation Department, which is responsible for administering the Exchange's compliance programs, includes 46 individuals dedicated to operation of CME's audit trail and trade practice surveillance programs, and 11 individuals dedicated to operation of CME's market surveillance program.⁴ The department is led by the Managing Director of Regulatory Affairs, who has 28 years of Exchange experience. Market Regulation has a knowledgeable and experienced compliance management team that includes the Director of Market Regulation (27 years of Exchange experience), the Director and Compliance Counsel (two years Exchange experience and 11 additional years industry related experience), five Associate Directors (Exchange experience ranging from nine years to 17 years), and three managers (Exchange experience of 22, 19, and 3 years). The remaining compliance staff is divided into systems development staff, data quality assurance analysts, daily investigators, general investigators, trading floor investigators, and administrative support staff.

Market Regulation appears to have adequate staffing levels to monitor CME markets. Notably, Market Regulation maintains approximately the same staff size noted in the Division's previous Rule Enforcement Review report dated June 26, 2002 ("2002 Review"), even though CME's average monthly volume of 80,225,417 during the current target period is more than 2.5 times its average monthly volume of 31,890,167 at the time of the 2002 Review. Significantly, however, most 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.

Market Regulation staff also attributes its ability to continue adequate trade practice surveillance

⁴ CME's market surveillance program is reviewed by the Division in separate Market Surveillance Rule Enforcement Reviews, and is not addressed in this report.

of greater trading activity without an increase in staff size in part to CME's continued development of sophisticated electronic surveillance tools for both electronic and open outcry trading.⁵ In addition, since the 2002 Review, the Exchange has modified the responsibilities of its daily, general, and trading floor investigators to better leverage each group's developed expertise and to more efficiently conduct trade practice investigations.⁶

B. Market Regulation Oversight Committee

In April 2004, CME established the Market Regulation Oversight Committee ("MROC" or "Committee"), a board-level committee organized to "provide independent oversight of the policies and programs" of CME's Market Regulation and Audit departments. The purpose of the MROC is to "enable those departments to administer effectively CME's self-regulatory programs."⁷

The MROC's charter requires that all MROC members be directors of CME Holdings Inc.⁸ In addition, MROC members must qualify as "independent" directors under the listing standards of the New York Stock Exchange; may not have membership privileges at CME; and may not be officers, principals, or employees of CME member firms. The charter further requires that the MROC consist of at least three people, all of whom, including the MROC's Chairman, are appointed by the Board of Directors of CME Holdings Inc. The MROC must meet at least quarterly, must keep minutes of its meetings, and may ask members of the Exchange's management to attend meetings and provide information.

⁵ CME's electronic surveillance systems are discussed more fully below at pages 34-40.

⁶ See pages 28-31 below for a detailed description of the division of duties among Market Regulation's trade practice investigators.

⁷ Charter of the Market Regulation Oversight Committee, Chicago Mercantile Exchange Holdings Inc. (October 24, 2005).

⁸ CME Holdings Inc. and the Exchange have identical Boards of Directors.

The MROC's specific responsibilities include reviewing and making recommendations with respect to the "responsibilities, budget and staffing" of the Market Regulation and Audit departments. In addition, the MROC reviews the annual performance evaluations and compensation determinations of CME's Managing Director for Regulatory Affairs and its Director—Audit Department, as well as any termination decisions with respect to these officers. Finally, the MROC is responsible for reviewing any rule changes or proposed rule changes "to the extent that such rules are likely to impact significantly the self-regulatory functions of the Exchange."

In addition to its regulatory review responsibilities, the MROC also is charged with certain periodic and annual reporting obligations. These include regular reports to the Board of Directors and an annual report to the Board summarizing the Committee's "activities, conclusions, and recommendations." On an annual basis, the MROC must also present the Board with its working agenda for the coming year. In addition, on a yearly basis, the MROC must reassess the adequacy of its charter and make recommendations where appropriate.

The Division reviewed the MROC's minutes for the four meetings that were held during the target period, as well as the MROC's 2004 Annual Report. In addition to committee members, the MROC's meetings also were attended by senior staff from Market Regulation and CME Clearing. The minutes reported that the committee discussed issues including rule interpretations and rule changes, CME's confidentiality policy and compliance with core principles, past rule enforcement reviews, composition of disciplinary committees, status of disciplinary matters, significant investigations, proposed budgets and staffing, and procedures for Market Regulation to apprise the committee of unusual or significant market events. The

minutes also indicated that the committee conducted a self-evaluation of its activities for the year. The MROC's annual report listed its objectives, responsibilities, and accomplishments.

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 program 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. CME Globex Audit Trail

Approximately 70 percent of all trades at CME are now executed on CME Globex, the Exchange's electronic trading system. CME Globex creates a comprehensive audit trail for electronic trades by automatically recording all messages entered into the system, and retaining them in a database for five years. The retained information includes all orders, order changes and order cancellations, all trades matched by the system, and the date and time of each message and each matched trade, recorded to the nearest millisecond. No message, whether it consists of an order, order modification or cancellation, can be erased from the system.

Orders may be entered into CME Globex by CME floor members; by clearing members or the futures commission merchants ("FCMs"), introducing brokers ("IBs"), or other clients they guarantee; or by customers of such guaranteed FCMs or IBs using a CME-certified front-end system to transmit their own orders.⁹ Each person who enters an order into CME Globex

⁹ A variety of front-end applications are available from CME, FCMs, IBs, and independent software vendors ("ISVs"). Customers using a front-end system may connect to CME Globex over the Internet or through the network or data center of an FCM, IB or ISV. Customers who qualify for and execute a direct access agreement with CME may submit their orders directly into CME Globex through their own direct connection.

must first log on to the system with a unique workstation operator identifier that identifies the individual operator and is included in the data retained by the system with respect to every order.

Workstation operator identifiers are assigned to CME Globex users either by CME or by a clearing member. CME itself assigns a unique identifier to each market participant who uses a CME-provided CME Globex Trader terminal or Enhanced Option System terminal to enter orders directly into the system. Such orders account for approximately 13 percent of all CME Globex orders. The remaining 87 percent of CME Globex orders are entered by clearing members, FCMs, IBs, or customers using electronic order routing systems connected to CME Globex through iLink, CME Globex's Application Program Interface. CME requires the clearing member that guarantees each iLink connection point to assign (or cause the FCMs and IBs it clears to assign) a unique workstation operator identifier to each person who enters orders into CME Globex through that connection point. Each automated trading system ("ATS") entering orders into CME Globex must also be given a unique workstation operator identifier, which must be associated with the name of the person directly responsible for operating or administering the trading of that ATS.

CME maintains a record of the workstation operator identifiers it issues, and of all identifiers issued by clearing members that are registered with CME in order to qualify the users of those identifiers for trading fee reductions based on, for example, Exchange membership or high trading volume.¹⁰ The Exchange also requires each clearing member that guarantees an iLink connection point to maintain records of all identifiers issued in connection with use of that connection point for at least five years, and to be able to provide to Market Regulation, upon request, the identity of the person to whom any particular identifier was assigned.

¹⁰ CME reviews these identifiers during periodic recordkeeping and fee audits to ensure accurate use of the identifiers and to ensure that traders receiving reduced trading fees continue to qualify for fee reductions.

Approximately 85 percent of CME Globex volume involves traders whose identifiers are registered directly with CME because they were issued by CME or have been registered with CME for fee reduction purposes. For this reason, and because CME compliance staff can obtain the identity of a market participant with an identifier not registered directly with CME by querying the clearing member involved, CME believes it is unnecessary to require that every retail client have an identifier directly registered with the Exchange.

The audit trail data for each electronic order includes the order's price, quantity, product, expiration month, customer type indicator ("CTI") code, order type (and order qualifier, stop price or trigger price, if applicable), order number, and account number, and, for options, a put or call indicator and strike price. All of this information must be entered into the system before CME Globex will accept an order. For modified or cancelled orders, audit trail data includes a record of the nature of the modification or cancellation. For executed orders, the data also includes complete fill information.

In addition to the audit trail data recorded and maintained in the CME Globex database, CME also requires each clearing member to maintain, or cause to be maintained for five years, a complete audit trail for all electronic orders entered into CME Globex through iLink by the clearing member and its customers.¹¹ In addition to a complete record of all messages transmitted to CME Globex, the audit trail maintained by the clearing member must include a record of each individual user's login and logout messages and a record of all orders that were

¹¹ Pursuant to the Commission's Advisory, *Alternative Method of Compliance With the Written Record Requirements*, 62 Fed. Reg. 7675 (Feb. 20, 1997), CME allows a clearing member to satisfy this requirement with respect to its FCM clients that have their own direct connection to CME Globex by requiring each such FCM to maintain the audit trail for all orders entered through its direct connection. CME has some inactive clearing members, which are firms that maintain clearing member status for trading fee purposes but engage only in proprietary trading, have no clients, and must themselves be cleared by an active clearing member. CME requires such inactive clearing members to maintain the required audit trail for their own trades, and excuses the active clearing members that clear them from maintaining the audit trail for those trades.

placed but rejected for any reason either by the order routing system or by CME Globex. Each firm with CME Globex trading privileges must also keep full, complete and systematic records of all CME Globex transactions, and retain them for five years.

B. Review Of Compliance With CME Globex Audit Trail Requirements

Market Regulation reviews each clearing firm's compliance with electronic audit trail requirements in connection with its program of annual back office audits of clearing members.¹² Market Regulation has substantially revised its audit procedures over the past two years to adapt to the significant increase in CME Globex volume, and it now tracks the electronic trading portion of its back office audits separately. These audits include review of randomly selected samples of front-end audit trail data for order routing systems connected directly to CME Globex. For each order in the sample data, analysts verify that all required data fields are present and that the order's receipt and transmission into CME Globex are properly recorded. The samples are also used to verify that front-end electronic audit trail data is retained for five years and readily available for the most recent two years. In addition, Market Regulation reviews the firm's procedures for assigning workstation operator identifiers and maintaining current information regarding the registered user of each identifier, and analysts review and verify the registered user information for a random sample of the workstation operator identifiers issued by the firm.

During the target period, analysts conducting back office audits began using two new computerized reports used to test the accuracy of the CTI codes and account numbers submitted by each clearing member. The CTI Code Report highlights inconsistencies in the codes submitted for given accounts. During each back office audit, the subject firm is required to

¹² CME's back office audits of clearing member compliance with open outcry recordkeeping requirements are discussed below at pages 22-24.

explain and correct inaccurate CTI data. The Account Number Report focuses on account number corrections made by the firm prior to trade clearing, and during an audit the subject firm is required to explain unusual or frequent account number changes, and correct any problems.

In the course of conducting back office audits of all 61 of CME's clearing members during the target period, Market Regulation reviewed the maintenance of electronic audit trail data by all 40 of its clearing members who guarantee CME Globex traders. The audits indicated generally high levels of compliance with electronic audit trail requirements. Market Regulation issued eight reminder letters to firms that initially did not produce data for the most recent two years of trading as quickly as required, but also verified after further testing that the required data were readily available. No other deficiencies were found. Division staff reviewed the electronic trading portions of five of the 40 back office audits involving electronic audit trail data, and found that they were thorough and well-documented.

One additional component of the audit trail for a relatively small number of CME Globex orders is comprised of paper order tickets. CME's rules require that customer orders for CME Globex trading that are telephoned to an FCM or IB must be immediately entered into CME Globex upon receipt if they are executable when received. If a customer order is not immediately executable, the date and time the order was received, the customer's account number and the terms of the order must be recorded on a written order ticket. The order must then be entered into CME Globex as soon as it becomes executable. During back office audits of clearing members, Market Regulation reviews samples of any paper order tickets for CME Globex orders prepared by the firm. No deficiencies with respect to such order tickets were found during the back office audits conducted during the target period. Market Regulation found that very few firms had any written CME Globex orders, either because CME Globex now can

accept orders virtually 24 hours a day, six days a week, or because most firms choose to deal with such orders by entering stop orders into the system immediately rather than managing the orders outside the system.

Market Regulation investigators have electronic access to all audit trail data from their desktop computers on trade date plus one for CME Globex orders and trades during the previous two years. They can also call up data covering CME Globex orders and trades during the previous five years from the Exchange's computer archives whenever older data is needed.

C. Open Outcry Audit Trail

Open outcry orders are typically transmitted to the CME trading floor by flashed hand signals, physical delivery of paper order tickets, or electronic order routing systems. When an open outcry order reaches the initiating firm's floor order desk, whether by telephone or by electronic order routing via either CME's Trade Order Processing System or a proprietary order routing system, the terms of the order, the account identifier, and the order number must be recorded on a paper order ticket at the desk.¹³ The order can then be transmitted to a floor broker by headset, flashing, hand delivery of the paper order ticket, or electronic transmission to a CME Universal Broker Station ("CUBS") terminal in the pit.¹⁴ Electronically routed orders can also be sent directly from a firm's back office to a CUBS terminal. Floor traders can use CUBS terminals to organize orders and transmit filled trade information back to the originating source

¹³ Order tickets can be created automatically by an electronic order routing system or written by hand.

¹⁴ Orders can also be transmitted electronically to a proprietary hand-held terminal in the pit, but use of such proprietary systems has dwindled as an increasing proportion of CME's trading volume has shifted from open outcry to CME Globex, and few are now used.

and to the CME clearing house.¹⁵ The CUBS system retains a record of the timing of all messages transmitted to or from each CUBS terminal.

When a customer order is executed, the floor brokers involved are required to record fill information either on an order ticket or on a non-sequenced trading card (“endorsement card”). Order tickets must be timestamped immediately when received on the floor (“entry time”) and when the fill is reported to the customer (“exit time”),¹⁶ and must contain, among other things, the account identifier and order number.¹⁷

Trades executed for a member’s personal account must be recorded in non-erasable ink on a single-sided trading card which contains a pre-printed sequence number and the floor member’s trading symbol.¹⁸ All transactions on the card must be recorded in the order in which they were executed. The floor member may not skip any lines when recording trades, and must cross out any unused lines before starting a new card. Erroneous information may be crossed out, but may not be obliterated. No more than six transactions may be recorded on a single card, and a new trading card must be used at the start of each 15-minute time bracket.

The trade data required to be recorded on both order tickets and trading cards includes the date, price, quantity, commodity, and contract month of the trade, the time bracket symbol of the 15-minute 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

¹⁵ CME maintains 29 CUBS terminals, including 11 in agricultural trading pits and smaller numbers in the currency, S&P and NASDAQ pits. Use of CUBS terminals has dwindled in the non-agricultural markets where side-by-side electronic trading is available.

¹⁶ At the beginning of each trading day, clearing members must ensure that each time clock used on the floor by the floor traders cleared by the firm is synchronized with the Exchange’s master clock.

¹⁷ A customer account number is not required at the time of execution for bunched orders entered by eligible account managers for accounts eligible for post-trade allocation, provided that such orders are allocated and recorded in accordance with Commission Regulation 1.35(a-1)(5).

¹⁸ Trades made for other members on the floor are recorded on non-sequenced trading cards known as endorsement cards.

and clearing firm. Options trades must also include the strike price, put or call indicator, and expiration month.

Order tickets and any related endorsement cards for filled orders and sequenced trading cards used during any 15-minute bracket period must be turned in for collection within 15 minutes of the end of the half-hour pickup period during which the tickets and cards were used, for timestamping by clearing firm staff who keypunch the data into the CME clearing system.¹⁹ Clearing members and floor traders must retain originals or duplicate copies, respectively, of all order tickets and trading cards for a minimum of five years, and make them available to Market Regulation investigators on request.

D. Trade Timing for Open Outcry Trades

CME's Regulatory Trade Timing ("RTT") system uses the various timing indicia from order tickets, trading cards, and electronic order routing data from CUBS terminals, along with time and sales information, to impute execution times for all open outcry trades, including those routed 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, RTT constructs a series of timing windows using relevant "start" and "end" times, and uses comparison of these windows to narrow the timeframe during which a trade could have occurred. Based on the narrowest timing window that can be constructed, the system then assigns an imputed execution time to the trade.

¹⁹ For example, trading cards used to record trades during time brackets "C" (7:30:00 to 7:44:59 a.m.) and "D" (7:45:00 to 7:59:59 a.m.) must be turned in no later than 8:15 a.m.

E. Enforcement of Trade Recordation Requirements for Open Outcry Trades

Market Regulation uses RTT execution times and the trade data collected from floor trading documents and electronic order routing to reconstruct open outcry trading activity and conduct trade practice surveillance with respect to open outcry trading.²⁰ 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, Market Regulation conducts two types of routine audit trail reviews to monitor compliance with Exchange recordkeeping rules. Market Regulation 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.²¹

1. Review Of Recordkeeping Exception Reports

The Exchange's Computerized Trade Reconstruction ("CTR") Monthly Enforcement Program allows Market Regulation to monitor floor member compliance with the Exchange's open outcry recordkeeping requirements through regular review of computerized recordkeeping exception reports generated by the Exchange's CTR system. The exception reports, which cover all open outcry trades, identify instances of audit trail recordation and data entry errors, including: (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

²⁰ Trade timing data is also incorporated into reports stored in CME's automated surveillance systems, discussed below.

²¹ An Associate Director for Regulatory Data Management, a senior data analyst and a data analyst, a senior systems analyst and a systems analyst, and an investigator are assigned to conduct these reviews.

where trading cards are used out of sequence; and (d) missing quotes, where the price recorded for a trade is not found in the Exchange's time and sales report for the relevant time period.²²

Market Regulation reviews CTR exception reports on a monthly basis to determine whether any floor members have bracket errors for 6 percent or more of their trades, time of execution errors for 8 percent or more of their trades, or have sequence errors or missing quotes with respect to five or more trades. Each floor member's compliance is tracked over a rolling twelve-month period. Floor members receive a warning letter the first time they exceed these monthly threshold levels for recordkeeping errors during any 12-month period.²³ Repeat offenses within any 12-month period are sanctioned by summary fines of \$500 for a second offense, \$1,000 for a third offense, and \$5,000 for each further offense. Summary fines are final and unappealable, and can be rescinded only if the floor member presents evidence within 15 days demonstrating that an administrative, clerical or other error caused the apparent recordkeeping violation. Market Regulation may also refer recordkeeping offenses that it deems egregious to the Probable Cause Committee for review and possible disciplinary action.²⁴

Reviews of CTR exception reports during the target period resulted in the issuance of 857 warning letters. Market Regulation assessed 162 summary fines totaling \$173,000 against 111 traders, including 106 fines totaling \$53,000 for second offenses, 40 fines totaling \$40,000 for third offenses, and 16 fines totaling \$80,000 for fourth offenses.²⁵ All fines assessed have been

²² A complete list of the exceptions is [redacted].

²³ The CTR system also produces daily exception reports, which are used to provide members with 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 trader's exception 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.

²⁴ CME's disciplinary committees are discussed below at pages 44-48.

²⁵ Given that summary fines are assessed based on a rolling 12-month period, some traders who received fines for a third or fourth offense during the target period received fines for preceding offenses prior to the beginning of the target period.

paid, except for four fines totaling \$8,000, three of which were assessed against former members who terminated their membership without paying, and one of which is uncollectible due to a chapter 7 bankruptcy.²⁶ No traders were referred to the Probable Cause Committee for disciplinary action concerning recordkeeping offenses.

Market Regulation also reviews monthly CTR exception reports regarding member firm compliance with order ticket and trading card timestamping requirements.²⁷ Firms are sanctioned when 7 percent or more of the trades cleared by the firm involve timestamping errors. Firms receive a warning letter the first time they exceed this threshold during any 12-month period, while further offenses within any 12-month period are sanctioned by summary fines of \$1,500 for a second offense, \$5,000 for a third offense, and \$10,000 for each further offense. These fines are rescindable only if within 15 days the firm presents evidence sufficient to reduce the firm's timestamping error percentage below the threshold level. Again, Market Regulation also may refer matters it deems egregious to the Probable Cause Committee for review and possible disciplinary action. During the target period, Market Regulation assessed a total of six summary fines totaling \$23,000 against four firms for timestamping errors, including two fines totaling \$3,000 for second offenses, and four fines totaling \$20,000 for third offenses.²⁸ No firms were referred to the Probable Cause Committee for recordkeeping-related disciplinary action.

²⁶ Market Regulation rescinded 382 additional fines based on presentation of evidence that the recordkeeping violations involved had been caused by administrative, clerical or other errors for which the traders involved were not responsible. The rescinded fines included 311 fines for bracketing errors, 37 fines for missing quotations, and 34 fines for trades out of sequence.

²⁷ At CME, the timestamping of these documents is performed predominantly by firm staff. The CTR exception reports concerning timestamping note three types of exceptions: (1) instances where required timestamps are missing; (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.

²⁸ In addition to these fines, three fines were rescinded based on evidence that the timestamping error percentage of the firm involved did not exceed the target level.

2. Back Office Audits

Market Regulation monitors the accuracy of the order ticket and trading card data submitted to the clearing system by clearing members through back office audits. As noted earlier, the accuracy of this data is important because CME's RTT system uses it to impute one-minute execution times for open outcry trades. Each clearing firm is audited once each year, together with its subsidiaries, if any.²⁹

Audits begin with review of background information including the firm's procedures for monitoring keypunch and timestamping errors, CTI coding errors, and trading card collection times; any deficiencies found in the previous back office audit of the firm; and any audit trail offenses in disciplinary actions involving the firm since the last back office audit.³⁰ Analysts also review CTR exception reports for indications of possible problems the firm may have with respect to timestamping, manually-recorded execution times or trade sequencing on personal trading cards.³¹

Each audit also includes an on-site visit, during which Market Regulation staff examine a randomly selected sample of the firm's personal trading cards, floor order tickets, CTI 3 trade endorsement cards, and CME Globex order tickets, if any, to determine whether the firm is meeting Exchange recordkeeping requirements with respect to collection of trading documents, entry and exit timestamps, account identification, use of non-erasable ink, and crossing out of

²⁹ As discussed above at pages 14-16, back office audits also include review of clearing member compliance with electronic audit trail requirements. Market Regulation now tracks the electronic trading and open outcry trading portions of back office audits separately.

³⁰ During the course of each back office audit, Market Regulation inspects each of the clearing firm's timestamp machines on the Exchange's trading floors, to verify the accuracy of the times they record. If the audit discloses orders with incorrect timestamps, the timestamp machines involved are re-checked.

³¹ The CTR exception reports used in preparation for these portions of back office audits include the following: the CTR Process Type "E" Timestamp Report, which lists all trades that should contain a handwritten execution time; the Timestamp In/Timestamp "T" Report, which lists all trades which should contain timestamps; the Card Sequence "C" Report, which lists all trades executed by floor members for their own accounts; and the CTR Error Report, which lists all trades for which required trade data were missing when the trade was submitted.

unused lines on personal trading cards. Analysts review a minimum of 50 personal trading cards, 50 floor order tickets, and 50 CTI 3 endorsement cards, using a checklist to ensure that all pertinent information is reviewed. In the case of larger firms, a Market Regulation manager may determine that a larger sample size is warranted, while in the case of smaller firms all documents in a category are examined if fewer than 50 are available.

Firms receive summary fines if an audit reveals recordkeeping violations in excess of allowable threshold levels. Specifically, fines are assessed if 10 percent or more of the reviewed documents show deficiencies with respect to timely collection of floor order tickets or failure to accurately record and submit order type indicators or flashed order indicators, or, if 20 percent or more of the documents show deficiencies in timely collection of sequenced trading cards or CTI 3 endorsement cards. Deficiencies within any 24-month period are sanctioned by summary fines of \$1,000 for a first offense, \$2,500 for a second offense, \$5,000 for a third offense, and \$10,000 for each further offense. Fines can be rescinded only if the firm presents evidence within 15 days demonstrating that the relevant error percentage should be reduced below the threshold level; otherwise, the fines are final and unappealable.

If a back office audit reveals sufficiently serious recordkeeping problems, Market Regulation may conduct a follow-up audit of the firm within two or three months of the regularly-scheduled annual audit. Market Regulation may also refer any firm recordkeeping offenses that it deems egregious to the Probable Cause Committee for review and possible disciplinary action.

As noted above, during the target period Market Regulation conducted 61 back office audits at CME's 61 clearing firms. In the course of these audits, analysts examined a total of 2,782 floor order tickets, 2,268 personal trading cards, and 695 CTI 3 endorsement cards. The

audits indicated generally high rates of firm compliance with Exchange recordkeeping requirements. Forty-seven (77 percent) of the 61 firms had no deficiencies resulting in summary fines. A total of \$39,000 in summary fines was assessed against 14 firms, including nine fines for first offenses within 24 months, eight fines for second offenses, and two fines for third offenses.

Division staff reviewed 21 of the 61 back office audits and found that they were thorough and well-documented. Each audit file included an audit summary, copies of original source documents examined during the audit, spreadsheets and work papers prepared by Market Regulation staff detailing findings concerning each transaction reviewed, an audit report, and records of fines assessed and paid, where applicable.

When reviewing trading documents during back office audits of clearing members, Market Regulation also examines the documents for individual trader compliance with recordkeeping requirements, and issues reminder letters to traders regarding any deficiencies identified. If trading documents examined in the course of a back office audit suggest potential trade practice violations by an individual trader, copies of the documents are forwarded to trade practice investigators for further inquiry. During the target period, the Exchange's back office audits resulted in the issuance of reminder letters to 30 floor members.³²

F. Safe Storage Capability

CME archives and can access complete audit trail data for both electronic and open outcry trading using its mainframe computer system at the Exchange's headquarters. Archive files for electronic and open outcry data are stored separately. In addition, a database on the mainframe contains combined cleared trade information on all trades regardless of execution

³² As noted above, floor members are also subject to recordkeeping review and summary fines for recordkeeping violations under the CTR Monthly Enforcement program.

platform, and a second database used for trade practice analysis contains separate electronic and open outcry data stores, but makes the data seamlessly accessible to analysts in combined result sets when this is desired. The Exchange also creates daily and monthly backups of all audit trail data for both electronic and open outcry trading on computer tape cartridges, which are sent offsite each day or month, respectively, for storage at data backup sites maintained by the data backup provider contracted by the Exchange. These sites are located a significant distance from CME's headquarters. The data is retained in storage for five years.

In addition, CME's audit trail data for electronic trades is replicated in real time on a separate mainframe system at the Exchange's Remote Data Center ("RDC"), also located a significant distance from CME's headquarters. The RDC mainframe mirrors the CME Globex trading host on the mainframe at the Exchange's headquarters at all times, and electronic trading can be shifted immediately to the RDC mainframe if the functioning of the headquarters trading host is interrupted for any reason. Trading in open outcry products could also be shifted to CME Globex in the event that the trading pits at CME's headquarters became temporarily unavailable. A majority of CME's open outcry products are already traded side by side, and clearing data concerning all cleared trades is replicated in real time on the RDC mainframe and would be available.³³

G. Conclusions and Recommendations

The Division found that CME maintains an adequate audit trail program. CME's audit trail records trade data in a manner that enables CME to identify customer and market abuses and provide evidence of rule violations. With respect to electronic trading on CME Globex, which now accounts for approximately 70 percent of CME's total volume, CME's audit trail is captured

³³ CME's automated surveillance systems are also backed up at and available for use from the RDC.

and retained in an unalterable electronic record which includes all messages entered into CME Globex, the terms and time of entry for each order, all order modifications, and all matched trades. This record allows Market Regulation staff to reconstruct CME Globex trading efficiently and effectively. CME conducts annual audits of clearing members' electronic audit trails for CME Globex orders and their compliance with related Exchange rules. CME also maintains a traditional paper audit trail for open outcry orders transmitted to the pit by headset, flashed hand signals, physical delivery of order tickets, or electronic order routing, 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, CME has adequate procedures for safe storage of audit trail data. Data is backed up daily and stored at an offsite backup storage location and at CME's separate Remote Data Center.

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.³⁴

³⁴ The 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.

A. Division of Trade Practice Surveillance Duties

Although the number of trade practice compliance staff has not significantly changed since the 2002 Review, the Exchange has modified the reporting lines and structure of its compliance staff to address the dramatic growth in trading volume, especially electronic trading. The Exchange's daily, general, and trading floor investigator programs now report to the Director and Compliance Counsel, a new position created in 2003. This has allowed the Director of Market Regulation, who has been directly involved in the development and each iteration of the Exchange's trade timing and automated surveillance systems for the past 20 years, to focus more on system development. CME's development of advanced regulatory systems has allowed the Exchange to better store, manage, and analyze the enormous amount of data that have resulted from the increased growth in electronic trading and use of automated routing systems. CME's advanced surveillance systems have fostered more efficient investigations by giving investigators quicker access to data and information.³⁵ They have also enhanced the Exchange's ability to detect trading violations by providing more sophisticated reports, such as the CME Globex Frontrunning Report, which analyzes trading data from long periods of time and enables isolation of patterns of potentially violative activity. Formerly, detecting such patterns had to be done by investigators through significant manual work. The Director of Market Regulation is also responsible for oversight of the regulatory programs through which Market Regulation monitors compliance with Exchange rules pertaining to dual trading, broker association

³⁵ With the increased development and deployment of various types of automated and semi-automated trading systems, the number of orders and resulting messages has grown exponentially. The number of daily order and trade messages has grown from approximately 11 million per month in 2001, to near 300 million a month in 2005. This has resulted in extremely large databases and the need to have efficient analysis programs to mine the data.

restrictions and top step trading restrictions, and the programs for conducting back office audits and CTR exception report review.³⁶

Structurally, since the Division's 2002 Review, there has been a shift in the functions of the Exchange's daily, general, and trading floor investigators so that they can more efficiently handle surveillance of the Exchange's increased trading volume. Traditionally, the Exchange's daily investigators have been responsible for all initial investigations, also called "inquiries," that resulted from anonymous and member complaints, as well as daily review of exception reports and analysis of cleared trades and other data with respect to both open outcry and electronic trading. The daily investigators also were responsible for operating the Exchange's video surveillance systems and analyzing the resulting video.³⁷ If a daily investigator identified trading activity that he or she believed violated an Exchange rule, the matter would be referred to a general investigator for further investigation. The general investigators were responsible for conducting full-scope investigations, including gathering and analyzing trading documents, conducting interviews, and preparing an Investigation Report for those matters referred to a disciplinary committee. General investigators also presented evidence in disciplinary proceedings.

While the Exchange's daily investigators continue to be responsible for the daily surveillance of assigned markets and conduct some initial investigations as part of their duties, and general investigators continue to perform many of the same functions as they did in the past, Market Regulation have noted that there is less of a bright line in terms of differentiating between an initial inquiry and an investigation. Moreover, because the daily investigators are assigned particular markets, each daily investigator has a unique understanding of how his or her

³⁶ CME's CTR Exception Report reviews and back office audits are discussed above at pages 19-24.

³⁷ See pages 32-33 for a detailed description of the Exchange's various video surveillance systems.

assigned markets perform. The daily investigators also have developed unique expertise in using the Exchange's sophisticated surveillance tools and analyzing electronic trading data. Thus, in order to leverage the daily investigators' discrete skills, and to allow general investigators to be more involved in the front-end of an investigation and daily investigators to remain more involved through the entire course of an investigation, Market Regulation has renovated its physical office space so that its daily and general investigators are now in close proximity to one another and work more closely together through the entire course of an investigation.

The Exchange also has expanded the role of its trading floor investigators. Trading floor investigators continue to observe all open outcry markets throughout the trading day.³⁸ However, if a trading floor investigator observes questionable trading activity or receives a complaint from an individual on the trading floor or an anonymous source, the trading floor investigator, rather than a daily investigator, may conduct the initial investigation of the suspect trading activity. Over the years, the Exchange has found that the vast majority of such complaints involve a single trade. Reviewing such complaints commanded a great deal of time on the part of daily investigators. Therefore, to make more efficient use of staff resources, and to take advantage of its trading floor investigators' in-depth knowledge of the trading floor and the relationships among individuals on the floor, Market Regulation has assigned its trading floor investigators the task of reviewing any suspicious activity that they identify while on the floor or that is brought to their attention through complaints. Trading floor investigators can quickly review videotape in a room just off the trading floor and examine trade data to determine if it appears that a trading

³⁸ Special emphasis is placed on observing Eurodollar options and agricultural contracts, all of which are markets where open outcry trading continues to thrive. In the past, the trading floor investigators paid particularly close attention to the Exchange's "equities quadrant" (S&P products, the NASDAQ 100 Stock Index, Russell 2000 Stock Price Index, and Nikkei futures and options) due to high volume, volatility, and anonymous complaints. However, due to the success of electronic trading in these markets and the resulting decrease in open outcry trading, these markets no longer require increased surveillance.

violation occurred.³⁹ If the trading floor investigator concludes that a violation may have occurred, the matter is referred to a general investigator. In such instances, the trading floor investigator will continue to work with the general investigator to the conclusion of the matter, including presenting evidence in any disciplinary proceeding. The Exchange has found that having its trading floor investigators work on investigations has been an excellent training tool. Additionally, it has freed up the daily instigators to spend more time on the daily surveillance of their assigned markets.⁴⁰

During the target period, twelve investigations were opened as a result of trading floor investigators' floor observations.⁴¹ Of these investigations, five were expanded into full-scope investigations, one of which resulted in significant disciplinary action. In that matter, a trading floor investigator witnessed suspicious activity in the NASDAQ-100 Index futures pit. In addition, Market Regulation also received an anonymous complaint regarding the same activity. The relevant trade data, along with videotape, clearly showed that a broker traded for his own account against a customer order in order to offset a long position that he had established for himself earlier in the day. Pursuant to a settlement agreement, the broker was fined \$10,000 and suspended from the trading floor for 15 business days.⁴²

³⁹ As explained below, the Exchange's video systems record the entire equity and interest rate quadrants of the trading floor throughout the trading day, and Market Regulation may with authorization conduct video surveillance of all quadrants in connection with investigations. Trading floor investigators have immediate access to these videotapes while the daily investigators have to request that the specific video be saved and wait a few days to receive the requested video. If a trading floor investigator reviews video and determines that it could be useful for an investigation, he or she will request that the video be saved.

⁴⁰ For example, daily investigators spend a significant amount of time reviewing block trades. Every block trade reported to the Exchange is examined to verify its compliance with CME Rule 526, which requires that the parties are Eligible Contract Participants, the quantity satisfies minimum size requirements, the price is fair and reasonable, and that report of the trade is timely.

⁴¹ In some instances, if a trading floor investigator witnesses a potential trading violation and Market Regulation also receives an anonymous complaint regarding the same activity, the source of the investigation is listed as "anonymous complaint" on Market Regulation's investigation log.

⁴² Investigation [redacted].

B. Video Camera Surveillance

CME's video surveillance program is frequently used by members to resolve outrades and is a vital component of the Exchange's trade practice surveillance and disciplinary programs. Three different systems comprise the Exchange's video camera program. Although the systems can be used to view small details, such as the writing on an individual's trading cards, none of the systems have audio capability.

The "Video Trade Resolution System" ("VTRS") is a digital video recording system that encompasses 34 cameras with various angles throughout CME's entire equities quadrant, including most of the active booth spaces. VTRS data are digitally stored and generally are maintained through trade date ("T") + 1. The Exchange's second video camera surveillance system is the "Video Logging System." The Video Logging System, which is older than VTRS, encompasses 44 analogue cameras throughout the "interest rate quadrant."⁴³ Video Logging System data are stored on videotape and are kept through T+ 3.⁴⁴ Both of these video systems run through the entire trading day and are used by members and member firms to resolve outrades. As noted above, trading floor investigators also utilize VTRS and Video Logging System data for reviewing suspicious activity that they identify while on the floor and investigating complaints.

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

⁴³ The interest rate quadrant includes Agency Notes, Eurodollar, EuroYen, Japanese Government Bonds, LIBOR, Quarterly Bankruptcy Index, Swap Futures, Treasury Bills, and Turn Rate.

⁴⁴ The technology associated with VTRS accounts for the storage difference between VTRS (T+1) and Video Logging (T+3).

the trading floors, has superior zooming capabilities. For example, a camera can be positioned to look over a person's shoulder in a trading pit or at a trading desk to view trading documents. Images are digitally recorded. In order to use Video Surveillance, staff must first obtain permission from the Director of Market Regulation.

As in the past, the Division again found that video from the Exchange's Video Surveillance system is an important investigative tool and frequently provides crucial evidence for prosecuting disciplinary cases.

The following example illustrates the importance of Video Surveillance evidence to prove a case. During the target period, Market Regulation received anonymous information alleging that two brokers, the primary brokers in an options pit, were forcing locals who traded directly opposite one of the brokers to record the trades on their trading cards as if they had given a CTI 3 trade (member trading for another member on the floor) to the other broker rather than recording the trade as it has actually occurred. Market Regulation taped the pit for eight business days and identified 12 instances of illegal trades, all of which were variations of the alleged conduct. In four instances, one broker indicated on his trading records that he filled customer orders opposite the other broker, whose trading records indicated that he had filled CTI 3 orders for locals.⁴⁵ The video showed that the broker filling customer orders actually traded directly with locals. Moreover, the videotape showed that for one of those instances, only the broker filling the customer order was present in the pit when the trade was apparently executed. In seven other instances, one of the brokers recorded cross trading customer orders opposite CTI 3 trades for locals. However, the videotape revealed that he actually traded directly with locals.⁴⁶

⁴⁵ The result of this activity was that both brokers collected brokerage fees, one for filling a customer order and the other for filling a CTI 3 order.

⁴⁶ In these instances, the broker collected brokerage fees for both sides of the trade.

In the last instance, one of the brokers reported that he had filled a customer order opposite the other broker, who reported that he had filled CTI 3 trades for locals not present in the pit. The videotape showed that the broker filling the customer order traded directly with the locals. Pursuant to settlement agreements, one broker was fined \$40,000 and suspended from trading for 15 business days, and the other broker was fined \$35,000 and also suspended from trading for 15 business days.⁴⁷

C. Automated Surveillance

Market Regulation uses a combination of several automated systems for detecting and investigating trade practice violations for both open outcry and electronic trading. These systems include the Virtual Detection System (“VDS”), Regulatory Trade Browser (“RTB”), RegWeb, Regulatory Analytic and Prognostic In-Memory Database (“RAPID”), and the Interested Party & Accounts Database (“IPACCT”).⁴⁸

1. Virtual Detection System

VDS, which is populated with data from the Exchange’s Regulatory Trade Timing System and cleared trade data, displays both exception and informational reports. VDS exception reports, which are reviewed daily, include the Trading Ahead of Customer Orders (“TACO”) Report, which compares the trading activity of the personal accounts of a filling broker to the customer orders that the broker filled during a market rally or a break; the Side-by-Side Report, which is similar to the TACO Report, except that it searches across related products traded simultaneously on CME Globex and via open outcry (“side-by-side trading”) to identify

⁴⁷ Investigation [redacted].

⁴⁸ VDS, RTB, and RegWeb data and reports are available on-line to Market Regulation staff for a minimum of three years. It also is expected that RAPID data will be available on-line to staff for a minimum of three years. As explained below, IPACCT is a historical database that includes older data.

possible instances of trading ahead violations⁴⁹; the Direct/Indirect Trading Against Customer Reports, which identifies instances in which a broker trades directly opposite a customer order or indirectly by using an accommodator; and the Direct/Indirect Wash Trades Report, which searches for two types of wash trades-- one wherein a single account is the buyer and seller in the same transaction, and the other wherein multiple accounts buy and sell amongst themselves and the trades appear to have no economic impact on any of the accounts involved; and the Top Step Report, which shows when a member trades for his or her own personal account in the S&P futures contract or any of the Eurodollar futures back 36 contract months while registered as a top step broker, or trades for his or her own account in any dual-trading restricted contract months that are traded in the contract month position where such member stands while registered as a top step broker.⁵⁰

VDS informational reports that assist in the investigation of potential trading violations include the Market Analysis Report, which searches Time and Sales to isolate rallies or breaks that occur throughout a trading session; the Broker Percentage Report, which looks at a broker's trading activity and expresses it as a percentage of his or her activity against that of another broker(s) and/or commodity(s); the Frequency of Appearance Report, which displays the number of times an account appeared on a given report for a given month; and the Profit and Loss Report, which display the daily profits and/or losses for a particular account over a selected time period.

VDS allows Market Regulation staff to view trade data across trade dates and to select data in a more customized manner. For example, staff can select data within all reports by

⁴⁹ For example, the Side-by Side Report will search across the open outcry S&P futures contract and the E-mini S&P futures contract simultaneously traded on CME Globex to identify potential trading ahead violations.

⁵⁰ See CME Rule 541 and 555 for further description of the Exchange's top step trading restrictions.

broker, trade date(s), commodity, contract month, individual firm or account number, or by dollar value in the Profit and Loss Report. VDS also has an ad hoc selection query feature that allows staff to search, sort, and drill down data through any VDS report using a wide variety of filters.⁵¹ The defaults and parameters for each VDS report differ by commodity. Although VDS users can modify the system's defaults and parameters for processing future data, data that have already been processed cannot be re-run using the modified default parameters.

The Division reviewed the parameters for the Exchange's VDS exception reports and found that the parameters were generally appropriate to identify the potential trading exceptions for which they were designed. However, the Indirect Trading Against Customer Report, which identifies instances in which a broker may have traded indirectly opposite a customer order by using an accommodator, lists only those instances in which the quantity filled by a broker for a customer order is equal to the quantity that the broker then trades for his or her personal account with an accommodator (who was also opposite the customer's order) within a specified time period. The report does not list instances where the quantity traded for the broker's personal account with the accommodator is less than the quantity traded earlier for the customer. In the Division's own trade practice investigations of trading at various exchanges, Division staff have found, and made exchange referrals concerning, instances where brokers and accommodators engaged in this second type of indirect trading against customer orders and then profitably traded out of their respective positions. Accordingly, the Division suggests that CME consider adjusting the parameters of its Indirect Trading Against Customer Report to include instances where the quantity traded for the broker's personal account is less than the quantity traded earlier

⁵¹ The ad hoc selection query function allows a user to select any of 19 different fields to be displayed in the report. For example, if a user is investigating potential wash trading, he or she might only be interested in potential violations involving certain brokers and certain account numbers in a particular contract month. Rather than look through an entire report, the user can sort the report to display potential violations based on selected criteria, *e.g.*, specific brokers and account numbers.

for the customer. The Division notes that CME is also able to identify potential instances brokers indirectly trading against customer orders by using other components of its automated surveillance systems to conduct trading pattern analysis.

2. Regulatory Trade Browser

The RTB system is a flexible ad hoc desktop query tool used by Market Regulation staff to further analyze potential trading violations identified in VDS exception reports, and to create customized reports in furtherance of investigations. RTB, which is primarily a reference tool, is populated with open outcry and CME Globex cleared trade data. RTB permits users to query any field of trade data or any combination of fields to create reports that can be displayed in multiple formats and downloaded into an Excel spreadsheet for further analysis. Trading activity can be queried and sorted by any criteria on the trade record for a specified period of time, such as by account number, trader, or clearing firm. For example, if VDS identifies a potential instance of wash trading, an investigator can query RTB to isolate all instances of a particular firm or account trading opposite itself over a selected time frame to determine if there is a pattern of wash trading.

3. RegWeb and RAPID

RegWeb is a system populated with detailed cleared trade and audit trail data, including matched, unmatched, modified and cancelled orders. It is an additional reference tool that is used by Market Regulation staff to create profiles for individual markets, brokers, traders, and accounts. These profiles can identify, among other things, the products, trading volume, and other statistics for market participants, and assist in identifying anomalous trading activity. For example, a statistical profile can be created to show the average transaction size for a particular account in a particular market over a specified time period. With respect to particular brokers or traders, the system can create a profile to see what markets they trade, how much volume they

trade within a certain timeframe, the individuals with whom they trade with the highest frequency, and the accounts that they trade for or against with the highest frequency. Such information allows staff to determine whether a trade or series of trades may be suspicious and merit further examination.

RegWeb also provides staff with access to the Exchange's Pre-Execution Discussion Report. CME Rule 539.C requires that when market participants engage in pre-execution discussions for CME Globex trading, one side must be exposed to the market for five seconds in futures and 15 seconds in options before the other party to the discussion can take the opposite side of the order. This report reviews the trading of a firm against its customers' orders and displays instances in which five seconds or less for futures, or 15 seconds or less for options, elapsed between order placement and trade execution. Market Regulation staff also accesses the Exchange's Front Running Report through RegWeb to monitor for front running in the Exchange's side-by-side markets (products that trade simultaneously in open outcry and electronically).⁵²

During the target period, the Exchange implemented "RAPID," a tool which is accessible through RegWeb that provides Market Regulation with a direct connection into CME Globex.⁵³ RAPID allows staff to view, in real-time, all CME Globex order messages. This has allowed the Exchange to take a proactive approach in monitoring electronic trading and addressing potential problems as they occur. For example, if staff knows that an economic report is due to be

⁵² The Front Running Report available through RegWeb is a beta report which the Exchange is continuing to refine. An older version of the Front Running Report also is available to staff on the "COOL" system. COOL is a system available to staff through their desktop computers that archives all hard copy reports and Time and Sales. COOL does not allow users to sort or format data. Market Regulation's market surveillance staff also receives data from equity exchanges that it uses to monitor for inter-market front running, *e.g.*, trading in CME equity products to front run trading in the underlying equities.

⁵³ RAPID was introduced and made available to a limited number of Market Regulation employees in June 2005. As it has been further refined, it has been made available to all Market Regulation data quality assurance analysts and daily investigators.

released that could affect the markets, they will use RAPID to monitor electronic trading activity immediately before and after the report is released. Market Regulation also uses RAPID to quickly review CME Globex trading if it learns from floor staff that trading in a particular electronic market, such as the e-Mini S&P futures contract, is taking off due to something that occurred in the S&P futures pit. RAPID also is used to quickly resolve questions and complaints regarding CME Globex trading. For example, a CME Globex user watching the CME Globex trading screen might call complaining about large orders being entered and then immediately disappearing from the screen. The caller assumes that someone is entering large orders and then immediately cancelling the orders. Market Regulation can quickly review such activity to determine whether the orders are being immediately cancelled, or whether one person or several persons are immediately hitting all or part of the large orders.⁵⁴

4. Interested Party & Accounts Database

The IPACCT Database, developed by Market Regulation in the 1980s, is a historical reference database that stores the names of clearing firms, members, corporate members, and market participants in special fee programs, in addition to the employees and registered contacts for those entities. It also stores the account numbers of registered entities. As a relational database, it also stores various pieces of data related to each of the aforementioned entities such as address, trading numbers and symbols, employment history, CME Globex user identifiers, and seat ownership. IPACCT is very useful to Market Regulation in that it allows investigators to identify relationships among entities, individuals, and/or accounts that can be useful evidence in an investigation. For example, if staff is reviewing possible instances of accommodation trading between two floor members, whether the two individuals have prior a relationship with one

⁵⁴ RAPID allows users to view a particular time period for a selected market to view the trading of a particular CME Globex user for a selected time period.

another, *e.g.*, worked together previously at a trading desk for the same employer, while not conclusive evidence, is a useful piece of information.

D. Timeliness And Adequacy Of Investigations

During the target period, the Exchange opened 175 investigations that were initiated from various sources. Of the 175 investigations, 85 were internally generated from the Exchange's automated surveillance systems and other routine oversight programs, 67 investigations from anonymous referrals, 17 investigations from identified referrals, five investigations from National Futures Association ("NFA") referrals, and one investigation from a Division referral. The 85 investigations initiated from internal sources included 22 investigations generated from exception report reviews, one investigation referred from an Exchange committee, 12 investigations referred from trading floor investigators, five investigations referred from the CME Globex Control Center, 14 investigations from routine block trade reviews, 17 investigations from unknown or non-specified sources, seven investigations from reviews of markets affected by specific news events (*e.g.*, the mad cow disease scare and the London terrorist bombings), and seven investigations were initiated from new information discovered during review of other investigations.

Market Regulation closed 172 investigations during the target period, including 27 investigations involving electronic trading and 145 investigations involving open outcry trading. The Division found that 138 of the 172 investigations (80 percent) were closed in less than one year. Of those 138 investigations, 53 were closed in less than one month, 68 investigations were closed within six months, and 17 investigations were closed within six months to one year. Thirty-four investigations remained open for more than one year, for periods ranging from one year to 28 months. The Division examined all of the 34 investigations that were open for longer than one year. The Division found that the reasons why these investigations were open for long

periods of time were acceptable, based on several factors. Specifically, most of these investigations involved multiple individuals and firms,⁵⁵ complex fact patterns involving numerous weeks of data, numerous interviews and document requests, and frequently required detailed review and analysis of videotape. Moreover, several of these investigations resulted in significant disciplinary action during the target period.

The Division thoroughly reviewed 94 of the 172 investigations closed during the target period. The sample reviewed included potential violations relating to, among other things, prearranged and noncompetitive trading, CME Globex trading violations, trading ahead of customer orders and trading ahead of market-moving news events. The Division found that although investigations were conducted across all contract markets, the majority of investigations were conducted in the Exchange's equity index and interest rate contracts, which accounted for a significant portion of the Exchange's volume during the target period.

The Division is satisfied that the Exchange conducts thorough investigations that include appropriate analysis. Investigation files are well documented, typically contain pertinent underlying trading documents, correspondence, computer reports, summaries of witness interviews and videotape evidence reviewed, and summaries of trading activity examined. Investigations also are expanded in scope, when necessary, to look for patterns of violations. Investigations that are closed with no further action or recommendation for issuance of a staff warning letter include either a "File Closing Form" or brief close-out memorandum. Files for investigations that are referred for formal disciplinary action include an Investigation Report and a memorandum containing recommendations with respect to charges. Investigation Reports describe the details surrounding an investigation, including how the matter is initiated, the facts

⁵⁵ The Division did not count an investigation as closed until it was closed with respect to all of the individuals and entities being reviewed. In several of the investigations that were open for longer than one year, the investigation was closed with respect to some of the involved subjects in less than one year.

developed during the course of an investigation, summaries of interviews, and staff's analysis and conclusions. Relevant computer reports are typically attached to the report, and, in some instances, the subject(s)' written responses to questions. File Closing Forms and close-out memoranda are not as detailed as Investigation Reports. Such documents typically contain a brief description of the investigation conducted and generally contain sufficient information for Division staff to make an informed decision regarding the investigation's adequacy.⁵⁶

E. Conclusions and Recommendations

The Division found that the Exchange maintains an adequate trade practice surveillance program. Market Regulation is led by an experienced management team that has effectively structured its staff to efficiently identify, investigate, and prosecute trading violations with respect to both open outcry and electronic CME Globex trading. The Division found that investigations were thorough, well documented, and completed in a timely manner.

The Exchange utilizes a combination of visual, video, and automated computer surveillance for monitoring and enforcing Exchange rules, and conducts various types of investigations in a manner capable of detecting trading violations. Videotape from the Exchange's video surveillance system frequently provided crucial evidence in disciplinary cases that resulted in significant sanctions. Since the Division's 2002 Review, Market Regulation has further refined its automated surveillance systems and developed a new tool, RAPID, which allows Market Regulation to conduct real-time surveillance of CME Globex orders and trading.

During the target period, Market Regulation closed 172 investigations, including 27 investigations involving electronic trading and 145 investigations involving open outcry trading. The Division found that the investigations were thorough and well-documented, and included

⁵⁶ The Division recommended in its 2002 Review that File Closing Forms include sufficient information for any reviewer to determine whether appropriate analyses were performed.

appropriate, well-founded analyses. A number of complex investigations involved analysis of substantial amounts of data and extended periods of trading activity. Market Regulation also completed investigations in a generally timely manner.

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 And Procedures

CME's principal disciplinary committees are the Probable Cause Committee ("PCC") and the Business Conduct Committee ("BCC"). The function of the PCC is similar to that of a grand jury: it receives and reviews investigation reports from Market Regulation, and determines whether there is a reasonable basis to bring charges for violations of Exchange rules. The BCC holds hearings on contested charges, and has overall responsibility for enforcing Exchange rules relating to trading and sales practice, as well as rules relating to trader conduct and the ethical responsibilities of CME's members and clearing members.⁵⁷

Each investigation report forwarded to the PCC is assigned to a panel, which is comprised of a chairman, three members of the Exchange, and three persons who are not members of CME.⁵⁸ The PCC has three chairmen, two of whom are members of CME and one non-member. The chairmen and panels are rotated independently of one another.

⁵⁷ CME's disciplinary process is governed by and described in Chapter 4 of CME's Rules.

⁵⁸ A person does not qualify as a non-member for purposes of sitting on either a PCC or BCC panel if he or she is, or within the previous 12 months has been: an owner or holder of Class B Trading Rights under CME Rule 106; a retired CME member with floor access privileges; an employee of a CME Class A clearing firm, Class A affiliate, cross margin firm, CME Globex API firm, or sub-accounting firm; an employee of any individual or entity described in CME Rule 106; an associated person or affiliate of any entity described in CME Rule 106; an employee

The PCC panel reviewing an investigation report must determine within 30 days of its receipt whether a reasonable basis exists for issuance of a notice of charges. Depending on its findings concerning the gravity of the offense and whether a clear violation of Exchange rules took place, the PCC also has the option of issuing a warning letter in lieu of charges.⁵⁹ When Market Regulation believes that charges should be issued, the investigation report will recommend that each rule violation involved be charged either as a “major” or a “minor” offense.⁶⁰ Major offenses are punishable by fines of up to \$1 million per violation plus the monetary value of any benefit received as a result of the violation, by suspension, or both, or by expulsion. Minor offenses are punishable by fines of up to \$100,000 per violation plus the monetary value of any benefit resulting from the violation, by suspension, or both. The maximum fine amounts for both major and minor offenses are double the amounts in effect at the time of the Division’s 2002 Review. Members suspended or expelled are barred from access to the Exchange floor, from obtaining member rates, and from leasing out an owned membership.⁶¹

Throughout the disciplinary process, Market Regulation will attempt to settle a case. Respondents may agree to settle a case without admitting or denying charged rule violations.

of an Introducing Broker guaranteed by a CME clearing firm; or an employee or representative of an entity which has cross-exchange trading privileges at CME.

⁵⁹ Market Regulation also is authorized, based on appropriate findings, to issue a warning letter rather than referring a matter to the PCC. A warning letter does not constitute either a finding of a rule violation or a penalty.

⁶⁰ Pursuant to CME Rule 432, major offenses include, among other things, fraud or bad faith; dishonest conduct; creating or reporting a false or fictitious trade; extortion or attempted extortion; acting as both buyer and seller in the same transaction; actual or attempted price manipulation; knowingly disseminating false, misleading or inaccurate information that could affect commodity prices; failing to cooperate with Exchange investigations as required by the rules; conduct substantially detrimental to the interest or welfare of the Exchange; and improper or unauthorized use of CME Globex. Under CME Rule 433, minor offenses include, among other things, conduct tending to impair the dignity or good name of the Exchange; dishonorable or uncommercial conduct; circulating rumors that tend to adversely reflect on the integrity of a contract; and violations of rules which are not specified as major offenses.

⁶¹ See CME Rule 406.

Proposed settlements are presented to the BCC for approval.⁶² If the BCC approves a settlement, it must file a written decision specifying the Exchange rules alleged to have been violated, and noting the penalty imposed and the fact that the respondent has accepted the penalty without admitting or denying guilt.

If the PCC directs that charges be issued, the Notice of Charges must indicate the rule or rules that the respondent is alleged to have violated; describe the conduct involved; advise the member of his or her rights, including the opportunity to submit a written answer to the charges within 21 days of receipt of the Notice; and advise the member of the time and place for the hearing. The respondent may waive the right to a hearing within 10 days of receipt of the Notice. Failure to file a written answer is not considered an admission or a denial of the charges.⁶³

When a Notice of Charges is issued, the case is referred to a BCC panel for a hearing. Each panel consists of a chairman, three Exchange members, and three non-members. The BCC has four chairmen, three of whom are members of CME and one non-member. As with the PCC, the chairmen and panels are rotated independently of one another.

Hearings must be conducted in accordance with Exchange rules that require a fair hearing. The respondent has the right to appear personally and to testify; to be represented by counsel or an Exchange member; to examine and obtain copies of all evidence against him or her, prior to the hearing; to submit evidence and call witnesses; and to cross-examine witnesses.⁶⁴

⁶² If a respondent makes a settlement offer to Market Regulation before a matter is heard by the PCC, the charging phase of the disciplinary process is suspended and the matter is referred directly to the BCC for consideration of the settlement offer. A settlement offer opposed by Market Regulation may be submitted to the BCC by the respondent only after charges are issued by the PCC.

⁶³ See CME Rule 407.

⁶⁴ The Respondent must provide copies of all documentary evidence and a list of all witnesses to Market Regulation at least ten days prior to the hearing.

At the hearing, Market Regulation presents the evidence supporting the charges, and bears the burden of establishing the basis for a finding of guilt on any charge by a preponderance of the evidence. A majority vote of the panel is required for a finding of guilt.⁶⁵

When a respondent is found guilty, the panel requests information or argument as to the appropriate nature and amount of sanctions. Exchange rules give the BCC the authority, among other things, to order a member to cease and desist from violative conduct; impose a fine of up to \$1 million per major rule violation, plus the monetary value of any benefit resulting from the violation; order restitution to any customer or other person or entity damaged by the member's conduct; impose a period of probation; suspend a member from all access to CME Globex or the Exchange trading floor and all other privileges of membership; or expel the member. If the BCC decides by majority vote that the conduct involved may warrant a penalty in excess of its authority, the panel chairman must refer the case to the Board of Directors for further hearing and decision.

Promptly following the hearing, the panel must issue a written decision of its findings, including the Notice of Charges and the answer, if any; a summary of the evidence or copy of the investigation report; a statement of findings and conclusions with respect to each charge, including the specific rules violated; and a declaration of the nature and effective date of any penalty imposed. The decision must also note the availability of an appeal.

A respondent who is found guilty of an offense or is otherwise aggrieved by a decision of or sanction imposed by the BCC may appeal to a hearing panel of the Board of Directors within ten days of receiving notice of the decision or sanction, provided that the sanction imposed is greater than \$10,000 or a five-day suspension and that Exchange rules do not specifically

⁶⁵ See CME Rule 408.

prohibit an appeal in the circumstances. CME's Managing Director of Regulatory Affairs may also appeal a BCC decision or sanction to a hearing panel of the Board within 10 days of receiving notice of it. Board hearing panels consist of a director appointed by the Chairman of the Board to serve as chairman of the panel, and two additional directors, one of whom must be a non-member of the Exchange.

The hearing panel determines whether sufficient grounds exist to grant the appeal, based solely on the written appeal request and the written response of the opposing party. If the appeal is granted, a hearing must be held within 60 days.⁶⁶ The hearing is limited to the record in the proceeding before the BCC, together with written appeal briefs by both parties. The panel may not set aside, modify or amend the appealed decision unless it finds by majority vote that the decision was arbitrary, capricious, or an abuse of the BCC's discretion, or was in excess of the BCC's authority or jurisdiction. The panel must issue a written decision, including a statement of the findings in the decision being appealed and of the panel's determination to affirm, set aside, modify or amend it. If the BCC decision is not affirmed in whole, the panel's written decision must also note the penalty to be imposed, if any, and its effective date. The decision of the panel is deemed a decision of the Board and the final decision of the Exchange.

B. Adequacy Of Sanctions

During the target period, the BCC closed 30 disciplinary cases, including 16 of the 20 cases sent to the BCC during the target period and all of the 14 cases pending before the BCC at the beginning of the target period. These 30 closed cases included five cases that, at the end of the target period, were closed as to some respondents but remained open as to others. Four

⁶⁶ The panel chairman can grant an extension for good cause.

additional cases sent to the BCC during the target period remained open as to all respondents at the conclusion of the target period.

To determine whether the Exchange's disciplinary process is imposing adequate sanctions on violators of Exchange rules, the Division reviewed all of the 30 closed disciplinary cases. The Division found that the sanctions imposed by the BCC during the target period appear reasonable relative to the violations alleged and the evidence presented. In the 30 closed cases, through seven hearings before BCC panels and 43 settlement agreements, the Exchange assessed a total of \$1,704,500 in fines against 33 individuals and four firms; ordered two members to pay \$4,612.50 in restitution to customers and one member to pay \$386,547.46 in restitution to a clearing firm; suspended 33 members for a total of 458 days, and ordered two respondents not to fill customer orders for a total of 180 days. The Exchange also imposed permanent bars on membership against two members, one guilty of noncompetitive trading and the other of fictitious trading, fraud and dishonest conduct.⁶⁷

The substantive trade practice violations charged most frequently in the 30 closed cases included noncompetitive trading, fictitious trading, and disclosing, trading ahead of, or trading against customer orders. In the aggregate, noncompetitive trading and fictitious trading were the most heavily-sanctioned violations. Noncompetitive trading drew \$349,000 in fines, \$2,050 in restitution, 258 days of suspension imposed upon 27 members, and the expulsion of one member. Three members charged with fictitious trading received \$1,110,000 in fines and 156 days of suspension, and one of the three was ordered to pay \$386,547.76 in restitution to his clearing member.

⁶⁷ A clerk who had placed unauthorized trades in a member's account was also fined and barred for one year from applying for membership.

Notable sanctions for noncompetitive trading resulted from a case in which Market Regulation analyzed data in response to a complaint about noncompetitive trading in the S&P 500 pit, and then videotaped the subjects for a two-week period.⁶⁸ Comparison of cleared trade data with the videotape identified more than 100 instances of potential noncompetitive trading and disadvantaging of customer orders. The Exchange sanctioned one of the brokers involved by ordering him to make restitution to the affected customers, expelling him from membership, and barring him from ever applying for any type of CME membership in the future.⁶⁹

Another example of CME's imposition of adequate sanctions for noncompetitive trading, even where respondents did not have prior substantive disciplinary violations, is found in a matter where two respondents were charged with prearranged trading and trading against customer orders in the Pork Belly futures pit over a two month period.⁷⁰ The charges were supported by videotape evidence. One of the respondents also was charged in a separate case with trading with a clerk in the Pork Belly pit and falsely reporting the trades as having been made with another broker.⁷¹ Although that respondent had no prior offenses, and the other respondent had only two summary recordkeeping fines on his record, the BCC accepted settlements under which the first respondent was fined \$30,000, suspended for 30 days, and ordered to refrain from filling customer orders for three months following the suspension, and the other respondent was fined \$25,000 and suspended for 20 days.

⁶⁸ Case No. [redacted].

⁶⁹ Proceedings against the two other brokers and three locals involved remained open at the conclusion of the target period but have now been closed. Each of the other two brokers were ordered to pay customer restitution, fined \$50,000, and barred from Exchange membership, one for five years and the other for four years. Two locals were fined \$50,000 and barred from membership for five years, and the third local was fined \$25,000 and suspended for six months.

⁷⁰ Case No. [redacted].

⁷¹ Case No. [redacted].

The Exchange also imposed significant sanctions in cases involving contested hearings. In one such case, Market Regulation charged a local in the S&P 500 pit with trading ahead of a customer order of which he had prior knowledge, passed to him by a pit clerk who observed the flashing of the customer order to a floor broker in the pit. The BCC found the local guilty of an act substantially detrimental to the Exchange, fined him \$12,500, and suspended him for five trading days. The clerk was found guilty of uncommercial conduct and fined \$12,500.⁷²

C. Timeliness Of The Disciplinary Process

The Division is satisfied that the disciplinary cases closed during the target period were handled in a timely manner. All but three of the 30 closed cases were closed by the disciplinary committees in less than one year following their referral by Market Regulation, including 17 cases resolved within six months.⁷³ The average time that these cases were before disciplinary committees was approximately 9 months. Of the three cases that were before disciplinary committees for more than one year, one was resolved in less than 13 months, one was resolved in less than 16 months, and one required approximately 21 months to resolve. These cases involved significant factors that required additional time, such as multiple subjects, extended settlement negotiations, parallel arbitration proceedings, extensive correspondence with attorneys for respondents, document requests, motions and hearings, and required analysis of large amounts of detailed audit trail evidence or videotape evidence. The PCC issued charges in all cases within less than two months of receiving them from Market Regulation.

⁷² The BCC found the pit clerk guilty of uncommercial conduct, and fined him \$12,500. The local appealed to the Board of Directors, which reduced his violation to unbusinesslike conduct but did not reduce the fine or suspension.

⁷³ The 27 cases closed within one year included five cases which, as noted above, were closed as to some respondents but remained open at the end of the target period as to other respondents.

D. Conclusions and Recommendations

The Division found that CME maintains an adequate disciplinary program that includes appropriate disciplinary procedures. During the target period, the Exchange took final disciplinary action in 30 cases, which involved 43 settlement agreements and seven hearings before the BCC. The cases were resolved in a timely manner and the sanctions imposed appear reasonable relative to the violations alleged and the evidence presented. The Exchange assessed \$1,704,500 in fines against 33 individuals and four firms, ordered \$4,612.50 in restitution to customers and \$386,547.46 in restitution to a clearing firm, suspended 33 members for a total of 458 days, and ordered two members not to fill customer orders for a total of 180 days. The Exchange also imposed permanent bars on membership against two members, one guilty of noncompetitive trading and the other of fictitious trading, fraud and dishonest conduct.

Half of the disciplinary cases closed during the target period involved noncompetitive trading, primarily on the floor, and these resulted in \$349,000 in fines, \$2,050 in restitution to customers, 258 days of suspension imposed upon 21 members, and the permanent expulsion of one member. Three fictitious trading cases involving three members drew fines totaling \$1,110, suspensions totaling 156 days, and \$386,547.76 in restitution to a clearing member. Trading ahead of or against customer orders drew fines totaling \$102,500. Finally, all but three of the disciplinary cases closed during the target period were closed in less than one year, and more than half were closed within six months.

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

CME customers are afforded voluntary dispute resolution through procedures set forth in Exchange rules.⁷⁴ Matters subject to arbitration include any claims or grievances between customers and members, member firms, and their employees that relate to or arise from transactions on the Exchange. Customers may compel members to arbitrate a dispute, but members may not compel customers. Arbitration claims must be filed within two years of the

⁷⁴ CME Rules 600 through 627.

date on which the customer knew or should have known of the dispute on which the claim is based.

Arbitration procedures are initiated when the party desiring to arbitrate (“claimant”) submits to Market Regulation a written description of the dispute, a Consent Form for arbitration at the Exchange, an Arbitration Cover Sheet and the appropriate filing fee. The claimant’s written statement must include “a clear description of the facts and circumstances involved in the dispute,” including the transactions or agreements involved, the persons and firms alleged to be responsible for the claimant’s loss, the dates of all relevant acts or omissions, and a detailed calculation of the amount claimed.⁷⁵ The Consent Form, which has a copy of CME’s arbitration rules attached, notifies the claimant of his or her rights and liabilities in connection with the arbitration, and of the filing fees and other costs involved. Filing fees are set on a sliding scale depending on the amount of the claim involved, and range from \$75 to \$500.

When a claim has been initiated, Market Regulation provides a copy of the claimant’s written statement to the respondent, who then has 21 days to file a written response. An unexcused failure to file a timely answer constitutes an admission by the respondent of the facts alleged in the claim. The response must admit the claim or describe the respondent’s basis for denying liability, and may include the respondent’s narrative description of the facts and circumstances involved, and any affirmative defense or other defense the respondent wishes to assert. It may also assert any counterclaim, cross-claim or third party claim arising out of the transactions or incidents which are the subject of the claim.⁷⁶ Responses to counterclaims, cross-claims or third party claims are subject to the same rules as the response to the original claim.

⁷⁵ CME Rule 602.

⁷⁶ All related counterclaims, cross-claims or third party claims must be submitted no later than the date on which the response to the original claim is due.

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 panel”).⁷⁷ In either case, the panel will consist of five arbitrators and a chairman, but mixed panels will have three unassociated arbitrators and two arbitrators who are members.⁷⁸ Both the Exchange members and the unassociated arbitrators serving on the panel are selected by Market Regulation from the membership of the Exchange’s Arbitration Committee, which includes 62 members of the Exchange and 30 unassociated, appropriately qualified outside panelists, appointed annually by the Chairman of the Board of Directors.

Customer claims that do not exceed a value of \$5,000 are decided by the arbitration panel based on the written submission of the parties, while claims with a value in excess of \$5,000 are decided after a hearing. The date of the hearing is set by the panel chairman. Prior to the hearing, if any party has failed to produce relevant documents requested by another party, the panel chairman may order production of the documents upon the written request of the party seeking the documents. The chairman may also require any Exchange member or member employee to appear and testify at the hearing. No later than 10 days prior to the hearing, each party must provide to all other parties and the Exchange copies of all documents that the party intends to offer into evidence, and a list of all witnesses the party intends to call at the hearing.

At the hearing, each party may be represented by counsel, and each party has the right to present evidence and witnesses in support of or defense to a claim, and to cross-examine witnesses. However, formal rules of evidence do not apply, and the panel is the sole judge of the

⁷⁷ 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.

⁷⁸ Panel chairmen do not vote except to resolve a tie.

law and the facts.⁷⁹ All testimony is given under oath. An audio record of the proceeding must be made and maintained until the decision of the panel becomes final.

The decision of the panel of arbitrators is made by majority vote, and must be in writing. Market Regulation must promptly serve copies of the decision on all parties. The panel may decide any matter in controversy and issue any order it deems necessary to fully resolve the dispute. Monetary awards made by the panel may include actual damages, with interest; punitive damages up to two times the amount of actual damages; all or part of the arbitration fee incurred by a prevailing party; all or part of the administrative costs of the arbitration; and the attorneys' fees incurred by a party due to another party's frivolous or bad faith claim, defense, or conduct during the arbitration. Awards must be satisfied within three days of receipt of notice of the panel's decision.⁸⁰ Decision of the arbitration panel in customer disputes are final and may not be appealed.

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, disputes between members are heard by five-person member panels, as described above, and not by mixed arbitration panels.⁸¹

⁷⁹ If the panel is in doubt as to any questions of law, it may refer the question to Exchange legal counsel for an opinion.

⁸⁰ Within three days of the receipt of such notice, a party may request that the panel modify or correct its decision if it involves an obvious material miscalculation or misdescription.

⁸¹ Unlike arbitration decisions in customer disputes, decisions in member-to-member disputes may be appealed to a hearing committee of the Board of Directors in narrowly limited circumstances. Appeals are not permitted unless (a) the case involved a potential recovery of more than \$10,000, or resulted in a non-cash award, and (b) the appellant alleges that the arbitration decision involved evident partiality, fraud, misconduct, or manifest disregard of applicable law by one or more arbitrators. The appellant must file a notice of appeal within three days of service of the arbitration decision; must deposit the full amount of any monetary award against him or her with Market Regulation in the form of a cashier's or certified check; and must file all written evidence and arguments within 14

C. Arbitrations Involving Certain CME Globex Trading System Issues

CME's rules now also provide for arbitration of certain claims against the Exchange relating to CME Globex trading. Arbitration is required for all claims relating to: (1) receipt of an incorrect CME Globex order status or the failure to have received an appropriate order status; (2) negligence of the personnel of the Exchange's CME Globex Control Center; or (3) "phantom" CME Globex orders.⁸² Such claims must be made within 10 business days of the date of the incident causing the loss. If the Exchange denies the claim and the claimant seeks arbitration, he or she must file a demand for arbitration within 10 business days after receiving notice of the denial. The arbitration is conducted by a panel of three arbitrators selected from an NFA list of arbitrators, with one arbitrator selected by the claimant, one by the Exchange, and the third selected by agreement of the parties or by the NFA President if the parties cannot agree. The usual Exchange rules regarding arbitrations apply. The panel must issue a written decision within 30 days after a hearing, and can only award the lesser of the claimant's actual loss or the loss that would have been incurred if the claimant had used its best efforts to mitigate the loss. No appeal is allowed.

Arbitration is also now required for disputes involving CME Globex trade cancellations or price adjustments made by the Exchange in accordance with its rules. A claim for losses in this connection must first be submitted to the Exchange, which forwards it to the party responsible for the orders that resulted in the trade bust or price adjustment, if the claim is one

days after filing the appeal. The hearing committee hears the appeal after the appellee has had an additional 14 days to reply. The committee may consider only the record from the arbitration proceeding and evidence relevant to the issue of partiality, fraud, misconduct, or manifest disregard of applicable law. If the hearing committee determines that the arbitration award should be vacated on these grounds, the matter is resubmitted to a new panel of arbitrators for rehearing.

⁸² A phantom order is defined as an order that was not authorized by any person but was caused by a failure, malfunction or negligent operation of CME Globex or any other Exchange system, service or facility, or whose terms were changed without authorization of the person placing the order solely as the result of such a failure or malfunction.

permitted under Exchange rules. If that party denies responsibility, the claim is arbitrated by a mixed panel of arbitrators.⁸³ The panel must issue a written decision within 30 days of the hearing. Awards are generally limited to out-of-pocket losses on the part of the claimant, not to exceed \$500,000 for a single incident. No appeal is allowed.

D. Arbitrations During The Target Period

Thirty-six arbitrations were closed during the target period, including 22 member-to-member arbitrations and 14 customer arbitrations. An additional six arbitrations were commenced during the target period but remained open at its conclusion. Sixteen matters were decided, 18 were settled or withdrawn by the parties, and two were determined to involve non-arbitrable claims. Of the decided matters, seven favored the claimant, and resulted in \$52,140.07 in awards. In nine instances, the arbitration panel found that there was no cause to grant an award. All of the 14 customer arbitrations closed during the target period were settled or withdrawn, or concluded by a finding that there was no cause to grant an award. Three of the member arbitrations involved member complaints against the Exchange in connection with CME Globex trading, including two complaints withdrawn by the claimants and one which did not state an arbitrable claim. The Division found that all of the arbitrations were conducted in conformance with the Exchange's arbitration rules and were completed in a timely manner.

E. 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

⁸³ If the allegedly responsible party is not subject to Exchange jurisdiction, the clearing firm through which the trade was placed may be held responsible.

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, 36 arbitrations were closed, including 14 customer arbitrations and 22 member-to-member arbitrations. Sixteen matters were decided, 18 were settled or withdrawn by the parties, and two were determined to involve non-arbitrable claims. Awards to claimants in decided matters totaled \$52,140.07. 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.