

**RULE ENFORCEMENT REVIEW  
OF THE  
MINNEAPOLIS GRAIN EXCHANGE, INC.**



**Division of Market Oversight  
September 6, 2013**

**Rule Enforcement Review of the  
Minneapolis Grain Exchange, Inc.**

**Commodity Futures Trading Commission - Division of Market Oversight**

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## I. INTRODUCTION

The Division of Market Oversight (“Division”) has completed a rule enforcement review<sup>1</sup> of the audit trail, trade practice surveillance, disciplinary, and dispute resolution programs of the Minneapolis Grain Exchange, Inc. (“MGEX” or “Exchange”) for compliance with related core principles under Section 5(d) of the Commodity Exchange Act (“Act” or “CEA”), both pre- and post-amendment by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.<sup>2</sup> The review covered the period of June 1, 2011 to May 31, 2012 (“target period”). Due to the passage of the Dodd-Frank Act, which became effective during the target period, the Division examined the Exchange’s compliance with pre-Dodd-Frank Act Core Principles 10 and 17 and post-Dodd-Frank Act Core Principles 10 and 18 (audit trail program); pre- and post-Dodd-Frank Act Core Principles 2 and 12 (trade practice surveillance program); pre-Dodd-Frank Act Core Principle 2 and post-Dodd-Frank Act Core Principle 13 (disciplinary program); and pre-Dodd-Frank Act Core Principle 13 and post-Dodd-Frank Act Core Principle 14 (dispute resolution program).<sup>3</sup> Although the Dodd-Frank Act amended and renumbered pre-Dodd-Frank Act Core Principles 2, 10, 12, 13 and 17, the Division notes that its

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<sup>1</sup> Rule enforcement reviews prepared by the Division are intended to present an analysis of an exchange’s overall compliance capabilities during 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. This report, and the findings and recommendations herein, represent the view of the Division only, and do not necessarily represent the position or view of the Commission or of any other office or division of the Commission.

<sup>2</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010) (“Dodd-Frank Act”). The Dodd-Frank Act’s effective date was July 16, 2011.

<sup>3</sup> The text of the applicable pre- and post-Dodd-Frank Act core principles are provided at the beginning of the audit trail, trade practice, disciplinary, and dispute resolution sections of this review.

recommendations would have been the same whether it evaluated the Exchange's compliance program under the old or amended core principles for the entire target period.<sup>4</sup>

## II. METHODOLOGY

For purposes of this review, Division staff interviewed compliance officials and staff from the Exchange's Department of Audits and Investigations ("A&I"). The Division also reviewed numerous documents used by A&I 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 surveillance investigation files;
- trade practice investigation, Exchange Room surveillance, and disciplinary logs;
- disciplinary case files;
- minutes of disciplinary committee, Board of Directors ("Board"), and Regulatory Oversight Committee ("ROC") meetings held during the target period; and
- compliance procedures manuals and guidelines.

The Division provided the Exchange with an opportunity to review and comment on a draft of this report on July 1, 2013. On July 10, 2013, Division staff conducted an exit conference with Exchange officials to discuss this report's findings and recommendations.

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<sup>4</sup> On May 10, 2012, the Commission issued its Final Rules, *Core Principles and Other Requirements for Designated Contract Markets*, 77 Fed. Reg. 36612 (June 19, 2012) ("Final DCM Rules"), which became effective on October 17, 2012, after the target period. Among other things, the Final DCM Rules revised guidance and acceptable practices for some core principles and, for several core principles, such as post-Dodd-Frank Act Core Principles 10 and 18 (audit trail program), 2 and 12 (trade practice surveillance program), 13 (disciplinary program), and 14 (dispute resolution program), codified rules in lieu of guidance and acceptable practices. See 77 Fed. Reg. 36,612, 36,614, 36,700-02, 36,704-07. Because the Final DCM Rules were not effective during the target period, the Division evaluated the Exchange's audit trail, trade practice surveillance, disciplinary, and dispute resolution programs under the pre-existing guidance and acceptable practices.

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

#### **A. Compliance Staff**

##### **Findings**

- MGEX's self-regulatory responsibilities are carried out by its compliance department, A&I, which consists of four staff investigators and is jointly headed by the Chief Regulatory Officer and the Exchange's Chief of Staff.
- During the target period, the Exchange experienced the departure of three A&I staff investigators. However, each vacated position was filled just prior to each departure. As a result, the Exchange never had fewer than four A&I staff investigators.
- Although A&I experienced a large number of staff departures during the target period, the Division did not find any evidence that staff turnover caused delays in the completion of self-regulatory responsibilities or that staff turnover was due to insufficient pay or benefits. Nevertheless, the Division encourages the Exchange to continue to monitor A&I staffing levels and the reasons for staff departures.
- The Division believes the Exchange has sufficient qualified personnel to fulfill its self-regulatory responsibilities with respect to the Exchange's audit trail, trade practice surveillance, disciplinary, and dispute resolution programs.

##### **Recommendations**

- The Division has no recommendations in this area.

#### **B. Audit Trail Program**

##### **Findings**

- CME Globex, the Exchange's electronic trading platform, maintains a complete electronic record of all orders entered and all transactions executed, including the terms and time of entry for each order, all order modifications/cancellations, and all matched trades. This record enables the Exchange to reconstruct electronic trading efficiently and effectively.
- The Exchange has created a comprehensive, systematic program to review its clearing members' compliance with electronic audit trail requirements, including proprietary modules that relate to Tag 50 IDs, CTI codes, account numbers, and record retention practices. However, the Exchange did not conduct any electronic audit trail reviews during the target period.
- The Division evaluated an electronic audit trail review completed in March of 2011 ("March 2011 Review"). In general, the Division found the March 2011 Review to be

thorough and well-documented. A&I reviewed all 13 of the Exchange's clearing members and identified 12 clearing members with missing electronic audit trail fields. A&I also found eight clearing members lacking formal procedures and documentation for assigning Tag 50 IDs and monitoring them for trading abuses. A&I did not take disciplinary action against the clearing members regarding any of these deficiencies. Instead, A&I issued a "Report of Findings" to each of the 13 clearing members describing A&I's findings and recommending enhancements to the clearing members' recordkeeping systems and procedures. The Division found that the Exchange did not conduct any follow-up reviews with the clearing members in the ensuing months after the March 2011 Review to determine whether they were meeting the expectations described by A&I in the Report of Findings.

- For open outcry trading, the Division found MGEX generally has adequate procedures for monitoring compliance with recordkeeping requirements through routine audit trail reviews that enable the detection and sanctioning of recordkeeping violations. However, MGEX did not conduct an open outcry audit trail review during the target period.
- The Division reviewed the most recent open outcry audit trail review conducted before the target period and found it to be well-documented and thorough with respect to the members included in the Exchange's review. However, 67 percent of members reviewed by the Exchange were not in compliance with open outcry recordkeeping requirements. The Division believes that the low level of compliance may be attributed to the infrequency of open outcry recordkeeping reviews and, consequently, the unlikely prospect of any sanctions.
- A&I has the authority, under MGEX Rule 2069.00, to summarily fine market participants for the "inaccurate, incomplete or untimely submission of data, records or information submitted to the Exchange." However, the Division found that the applicable summary fine schedule is not publicly available and provides for an initial summary fine amount that is less than \$1,000.
- MGEX has adequate safe storage capability for its trade data. The Exchange retains five years' worth of open outcry trade data in both computerized and hard copy form, and five years' worth of electronic trading data. Both open outcry and electronic data are stored on-site, off-site, and maintained at a disaster recovery site a significant distance from MGEX headquarters.

### **Recommendations**

- The Exchange should conduct electronic and open outcry audit trail and recordkeeping reviews at least annually, as well as timely follow-up reviews within six months when the Exchange finds members who fail to maintain a high level of compliance with Exchange rules.
- The Exchange should publish its summary fine schedule in the Exchange rulebook and revise its summary fine schedule to provide for fine amounts that are clearly sufficient to

deter information submission offenses, beginning with an initial summary fine amount of at least \$1,000.

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

### **Findings**

- The Exchange generally maintains an adequate trade practice surveillance program. The Time Audit Report and the Broker Error Type Report serve as the Exchange's automated trade practice surveillance system for identification of possible trade practice violations for electronic and open outcry trading. The Exchange has also enhanced its automated trade practice surveillance system with a web-based application that integrates new and existing reports.
- A&I staff investigators conduct surveillance of open outcry trading primarily during the openings and closings of all options contracts but also randomly observe trading activity at staff's discretion should market conditions warrant.
- MGEX closed 14 trade practice investigations during the target period. In addition, after the target period, the Exchange closed two investigations that were opened during the target period. All 16 investigations were completed in a timely manner. However, the Division identified two areas of concern among the closed investigations.
  - First, the Division found that 13 investigations were too narrow in their scope, consisting of a review of a single trading day.
  - Second, the Division found seven investigations where A&I did not fully conduct and/or document its analysis. Some of these investigations involve more than one instance where A&I did not fully conduct and/or document its analysis. In six investigations, A&I determined that orders had "sufficient market exposure," but did not describe the amount of exposure given in relation to existing market conditions. In one investigation, A&I did not review the customer's original order and explain or document why the subject changed a filled trade from his personal account to a customer account. Finally, in three investigations, A&I did not calculate profit and loss for the subjects' trades at issue in order to make a thorough evaluation of the subjects' intent.

### **Recommendations**

- The Exchange should take the following measures to ensure that trade practice investigations are consistently thorough and well-documented:
  1. Expand the scope of Exchange investigations to include additional trading dates in order to identify possible patterns of trade practice violations;



2. Analyze and document order exposure times in relation to existing market conditions when determining the sufficiency of market exposure;
3. Review underlying orders and the reasons for account changes in investigations where there is a post-execution account change involving customer and trader accounts; and
4. Calculate profit and loss in order to thoroughly evaluate the subject's intent when investigating potential trade practice rule violations, including, but not limited to, accommodation and/or money pass exceptions.

## **D. Disciplinary Program**

### **Findings**

- The Division found that MGEX has a generally adequate disciplinary program that includes appropriate disciplinary procedures. The Exchange has the authority to investigate possible rule violations, prosecute cases, and discipline members who are found guilty. Respondents receive adequate notice of the claims against them, and have sufficient opportunity to request a hearing, present their defenses, and offer evidence. Respondents also are afforded the right to counsel and may enter into settlement negotiations.
- During the target period, the Exchange maintained two disciplinary committees, the Futures Trading Conduct Committee ("FTCC") and the Business Conduct Committee ("BCC"). The FTCC had jurisdiction over matters concerning futures and option trading, including consideration of possible trading violations, while the BCC had jurisdiction over all other potential violations, such as registration issues, clearinghouse matters, position limits and margins. In October 2012, the Exchange amended its disciplinary rules and consolidated the FTCC and BCC into a single disciplinary committee with jurisdiction over all disciplinary matters.
- During the target period, one investigation involving substantive trade practice violations was referred to the FTCC. The case resulted in settlements with each respondent and fines totaling \$40,000. The Division found that the fines imposed were generally reasonable relative to the violations alleged and the evidence presented. The Division also found that the case was resolved in a timely manner once the investigation was referred to the FTCC.

### **Recommendations**

- The Division has no recommendations in this area.

## **E. Dispute Resolution Program**

### **Findings**

- Exchange rules provide fair and equitable procedures for the resolution of customer disputes. Each party has the right to counsel and each party receives adequate notice of the claims presented against them and an opportunity to be heard on all claims. MGEX's arbitration procedures require a prompt hearing and authorize prompt, written, final settlement awards that are not subject to appeal within the Exchange.
- There were no arbitrations at MGEX during the target period.

### **Recommendations**

- Since there were no arbitrations during the target period, the Division was unable to evaluate the adequacy of the Exchange's dispute resolution program.

## **IV. PRODUCTS AND TRADING VOLUME DURING THE TARGET PERIOD**

Total trading volume at MGEX during the target period was 1,407,869 contracts, an average of 117,322 contracts per month. MGEX offered 12 products for trading during the target period, but two products accounted for all of the total volume. Hard Red Spring Wheat ("HRSW") futures and options accounted for 98 percent and two percent of total volume, respectively.<sup>5</sup> After the target period, on August 13, 2012, the Exchange launched apple juice concentrate ("AJC") futures and options. To date, AJC contracts are trading on a limited basis. Additional contract volume, venue, and market share information is provided in Figures 1, 2, and 3 below.

Figure 1 below depicts the distribution of Exchange volume across products and venues during the target period.<sup>6</sup> As of December 19, 2008, MGEX closed its trading floor and transitioned to electronic trading for all futures trading, which accounted for approximately 86.7

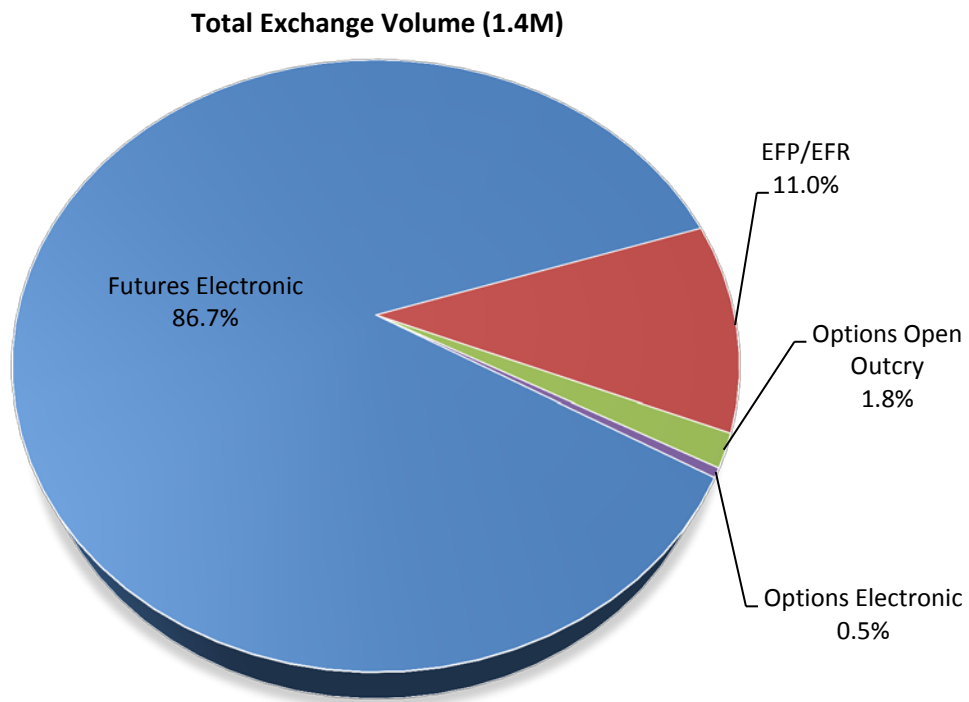
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<sup>5</sup> In addition to the HRSW contract, the Exchange offered electronic trading for five agricultural index futures and options contracts during the target period: National Corn Index ("NCI"), National Soybean Index ("NSI"), Hard Red Spring Wheat Index ("HRSI"), Hard Red Winter Wheat Index ("HRWI"), and Soft Red Winter Wheat Index ("SRWI").

<sup>6</sup> Data in Figure 1 were obtained from the Exchange's trading volume statistics.

percent (1,220,737 contracts) of the Exchange’s total volume during the target period. However, the Exchange continues to offer open outcry trading for options contracts which comprised approximately 1.8 percent (24,989 contracts) of total Exchange volume while electronically traded options contracts contributed 0.5 percent (7,006 contracts) to the Exchange’s total volume.<sup>7</sup> Exchange of Futures for Physicals (“EFP”) and Exchange of Futures for Risk (“EFR”) trades collectively accounted for 11 percent (155,137 contracts) of total Exchange volume during the target period.

**Figure 1: MGEX Volume Distribution During the Target Period**



<sup>7</sup> Options contracts trade in a room located at the Exchange’s headquarters (“Exchange Room”) that is separate from the closed trading floor. Electronically traded futures and options contracts are traded on Globex, the CME Group, Inc.’s (“CME Group”) electronic trading platform.

Figure 2 below illustrates the fluctuation in monthly contract volume at the Exchange from January 2006 through December 2012.<sup>8</sup> The target period for this review, and the last MGEX RER in 2009 (“2009 RER”), is shaded to highlight contract volume levels at the Exchange during the respective target periods.<sup>9</sup> During the target period for the 2009 RER, the Exchange set four all-time monthly volume records that still stand.<sup>10</sup> In June 2011, the beginning of the target period for this review, MGEX set an all-time monthly record for volume with 215,581 contracts traded, largely followed by below average monthly volume through 2012.<sup>11</sup>

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<sup>8</sup> Data in Figure 2 were obtained from the Exchange’s trading volume statistics.

<sup>9</sup> The target period for the 2009 review was October 1, 2006 through June 30, 2008. *See* CFTC, Div. of Mkt. Oversight, Rule Enforcement Review of the Minneapolis Grain Exchange (Aug. 27, 2009), *available at* <http://www.cftc.gov/ucm/groups/public/@iodcms/documents/file/rerngexmineapolis081909.pdf>.

<sup>10</sup> The monthly volume records include April (182,299 contracts), August (216,593 contracts), and October (200,448 contracts) of 2007 as well as January (198,770 contracts) of 2008.

<sup>11</sup> The average monthly volume figure referred to in this paragraph, and depicted in Figure 2, equals 129,296 contracts. It was calculated using total monthly contract volume figures from January 2006 through December 2012. Average monthly trading volume during the target period was 117,322 contracts.

**Figure 2: MGEX Total Monthly Trading Volume**

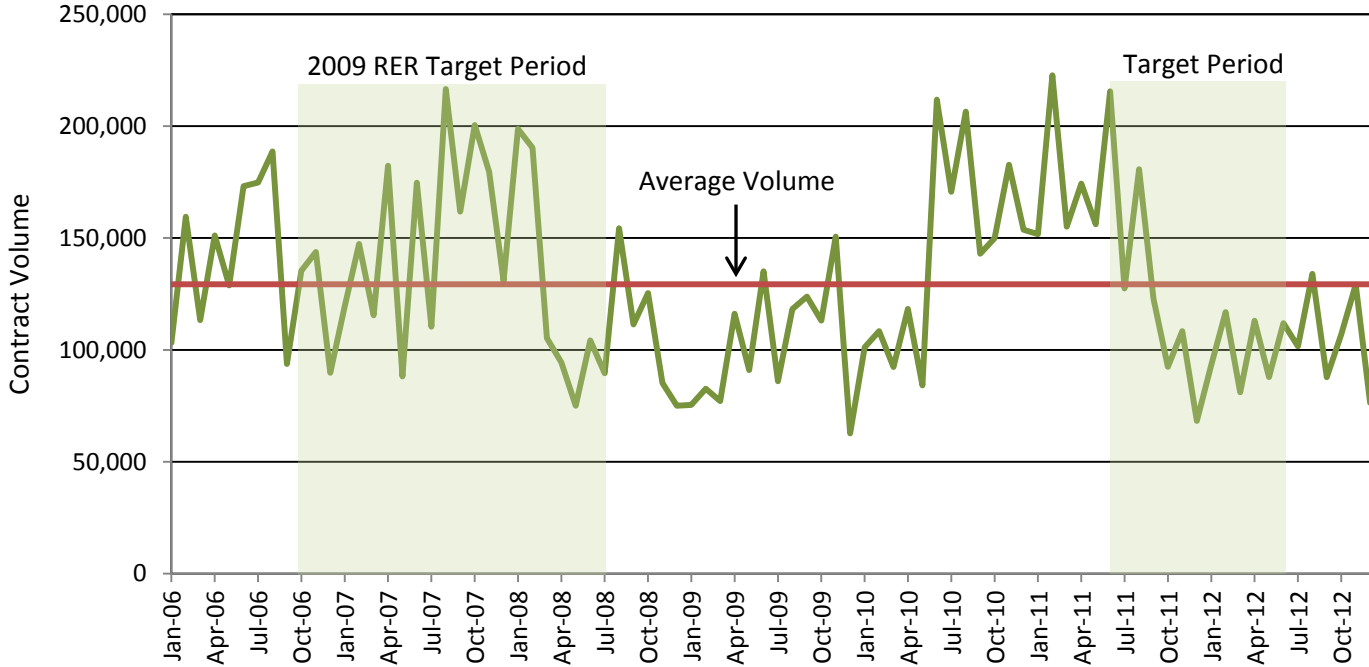


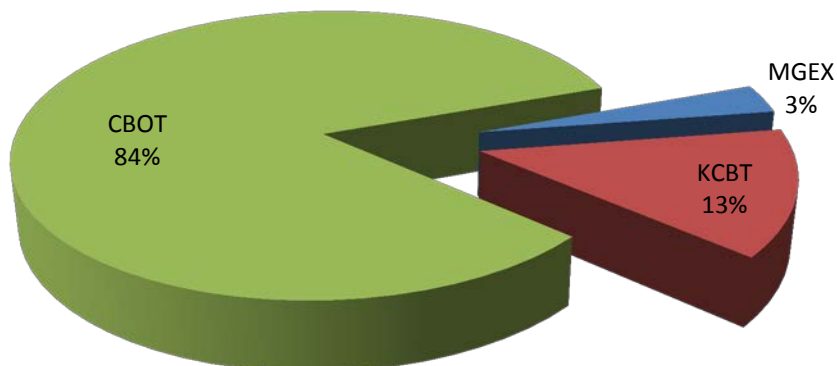
Figure 3 below shows the approximate 2012 market share of each U.S. designated contract market offering wheat futures and options trading.<sup>12</sup> In 2012, MGEX-traded HRSW futures and options accounted for approximately three percent of exchange-traded wheat contracts while CBOT and KCBT-traded wheat futures and options accounted for 84 percent and 13 percent, respectively.<sup>13</sup> By comparison, in 2009, MGEX-traded HRSW futures and options accounted for approximately five percent of exchange-traded wheat contracts while CBOT and KCBT-traded wheat futures and options accounted for 79 percent and 16 percent, respectively.<sup>14</sup>

<sup>12</sup> Figure 3 compares combined futures and options contract volume in MGEX HRSW, Kansas City Board of Trade (“KCBT”) Hard Red Winter Wheat, and Chicago Board of Trade (“CBOT”) Wheat. CBOT wheat product volumes connected to Mini-Sized Wheat, MGEX-CBOT Wheat Spreads, Wheat Calendar Spreads, and Black Sea Wheat are not included in Figure 3.

<sup>13</sup> Data in Figure 3 were obtained from each exchange’s trading volume statistics.

<sup>14</sup> On October 17, 2012 CME Group, CBOT’s parent company, agreed to buy KCBT. CME Group completed its acquisition of KCBT on December 3, 2012.

**Figure 3: 2012 Market Share - Exchange-Traded Wheat (futures + options)**



## **V. COMPLIANCE STAFF**

### **A. A&I**

MGEX’s self-regulatory responsibilities are carried out by A&I, which consists of four staff investigators and is jointly headed by the Chief Regulatory Officer (“CRO”) and the Exchange’s Chief of Staff.<sup>15</sup> The CRO reports to the ROC and is primarily responsible for overseeing A&I’s performance of its self-regulatory responsibilities, including management of the Exchange’s audit trail, trade practice surveillance, market surveillance, disciplinary, and dispute resolution programs.<sup>16</sup> For example, the CRO reviews investigations prepared by A&I staff investigators, assesses surveillance matters, and evaluates and administers disciplinary actions such as warning letters and settlements. The Chief of Staff reports to the President of the

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<sup>15</sup> The CRO in place at the close of the target period also served simultaneously as Corporate Counsel for the Exchange. The current CRO and the Chief of Staff serve additional Exchange roles as Chief Compliance Officer of MGEX’s Derivatives Clearing Organization (“DCO”) and Assistant Corporate Secretary, respectively.

<sup>16</sup> The Division notes that this review does not contain any judgments with respect to the Exchange’s compliance with post-Dodd-Frank Act Core Principle 16, *Conflicts of Interest*.

Exchange and is primarily responsible for overseeing A&I administrative matters. These responsibilities include hiring investigators, conducting annual A&I employee performance evaluations, and assigning and monitoring the timeliness of A&I work. While performing many of these, and other A&I related responsibilities, the Chief of Staff works collaboratively with the CRO. For example, the CRO and the Chief of Staff jointly discuss and calculate A&I expenses to prepare A&I's proposed annual budget.<sup>17</sup>

The current CRO served as CRO from 2009 to May of 2012 and was reappointed in April of 2013. The CRO in place at the close of the target period joined MGEX in 2010, was appointed CRO in May of 2012, and left MGEX in April of 2013. The Chief of Staff joined MGEX in 1996 and became Chief of Staff in 2005.

In the 2009 RER, the Division recommended that the Exchange increase A&I's staffing level to ensure that, among other things, the Exchange can efficiently and effectively perform routine surveillance activities, keep pace with volatile trading periods, and complete investigations in a timely manner, including conducting prompt interviews after a potential trading violation has been detected. During the 2009 RER target period, A&I consisted of two staff investigators and a part-time administrative assistant. In response to the Division's recommendation, the Exchange increased A&I's staffing level to four full-time investigators.

During the target period, the Exchange experienced the departure of three A&I staff investigators. However, each vacated position was filled just prior to each departure. As a result, the Exchange never had fewer than four A&I staff investigators.<sup>18</sup> Although A&I

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<sup>17</sup> A&I's proposed budget is first submitted to the ROC and then reviewed by the Exchange President before being presented to the Board of Directors for final approval.

<sup>18</sup> At the end of the target period, A&I consisted of two experienced investigators that have been with the Exchange since 2006 and 2008, respectively, as well as two investigators hired in 2011 and 2012, respectively.

experienced a large number of staff departures during the target period, the Division did not find any evidence that staff turnover caused delays in the completion of self-regulatory responsibilities or that staff turnover was due to insufficient pay or benefits. Nevertheless, the Division encourages the Exchange to continue to monitor A&I staffing levels and the reasons for staff departures.<sup>19</sup>

A&I staff investigators are responsible for conducting trade practice surveillance, market surveillance, financial surveillance, and audit trail reviews. In conducting their work, staff investigators often consult with the Exchange's Market Operations Group ("MOG"), which is responsible for, among other things, managing the database that houses Exchange trade/order data.<sup>20</sup> Staff investigators rely on MOG to provide certain historical trade/order data used in investigations. MOG staff also work closely with staff investigators to develop the Exchange's automated electronic surveillance programs. In addition to their compliance responsibilities, staff investigators dedicate time to training and the development of all aspects of the Exchange's surveillance and audit trail review programs.<sup>21</sup>

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<sup>19</sup> In its 2009 RER, the Division recommended that the Exchange examine the underlying reasons for the large number of staff departures during the 2009 RER target period.

<sup>20</sup> Occasionally, staff investigators consult attorneys in the Exchange's Office of Corporate Counsel regarding legal questions related to investigations. Staff investigators may also consult with the Exchange's Membership Department, which provides biographical information regarding members associated with an investigation.

<sup>21</sup> Training occurs informally and not programmatically. The Exchange conducts most training by having a new investigator shadow an experienced investigator or through meetings where investigators and the CRO discuss open investigations. Investigators also receive training by attending the annual FIA Law and Compliance workshop. See *infra* Sections VI and VII for a discussion of enhancements to the Exchange's audit trail and trade practice surveillance programs, respectively.



## **B. Conclusions**

The Division believes the Exchange has sufficient qualified personnel to fulfill its self-regulatory responsibilities with respect to the Exchange's audit trail, trade practice surveillance, disciplinary, and dispute resolution programs.<sup>22</sup>

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

## **VI. AUDIT TRAIL PROGRAM**

### **Pre-Amendment of the CEA by the Dodd-Frank Act**

#### **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 5 years.**

### **Post-Amendment of the CEA by the Dodd-Frank Act**

#### **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 —**

**(A) to assist in the prevention of customer and market abuses; and**

**(B) to provide evidence of any violations of the rules of the contract market.**

#### **Core Principle 18 – Recordkeeping:**

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<sup>22</sup> Market surveillance is an additional Exchange rule enforcement responsibility; however, such responsibility is not the subject of this review.

**The board of trade shall maintain records of all activities relating to the business of the contract market —**

**(A) in a form and manner that is acceptable to the Commission; and**

**(B) for a period of at least 5 years.**

During the entirety of the target period, the acceptable practices set forth in Appendix B to Part 38 of the Commission's regulations provided that an effective contract market audit trail should capture and retain sufficient trade-related information to permit contract market staff to detect trading abuses and to reconstruct transactions within a reasonable period of time.<sup>23</sup> 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. 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

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<sup>23</sup> See discussion of applicable guidance and acceptable practices *supra* note 4.

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

## **A. Audit Trail for Electronic Trading**

### **1. Audit Trail Creation and Contents**

All electronic trading at MGEX is conducted on Globex, the CME Group's electronic trading platform.<sup>24</sup> 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 modifications and cancellations, all trades matched by the system, and the date and time of each message and each matched trade, recorded to the nearest millisecond. The system does not allow traders or exchange staff to erase or alter any message from the audit trail whether it consists of an order, order modification or cancellation, or matched trade.

The audit trail for each electronic order includes the commodity, price, quantity, contract month/year, customer type indicator ("CTI") code, buy/sell indicator code, exchange indicator code, clearing member code, order type (and order qualifier, stop price or trigger price, if applicable), account number, and for options, a put or call indicator and strike price. All of this

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<sup>24</sup> Electronic trading accounted for approximately 87 percent of all trades executed at MGEX during the target period, with an average of 102,312 electronically traded contracts per month. The remaining 13 percent of trades were executed via EFP, EFR, or open outcry.

information plus a unique workstation operator ID (“operator ID” or “Tag 50”) must be entered before the Globex system will accept an order. Each order carries a trader order number, assigned by the front-end system used by the trader entering the order, and a host order number, assigned by Globex upon receipt of the order. These numbers facilitate tracking the order’s history within the trader’s computer system and within Globex, respectively. For modified or cancelled orders, audit trail data includes a record of the nature of the modification or cancellation. For spread orders, audit trail data includes a spread ID, the spread type, and the number of legs in the spread. For executed orders, the data includes the complete fill information.

A written order must be prepared for orders that cannot immediately be entered into Globex and must be entered when the orders become executable in the sequence the orders were received.<sup>25</sup> All customer orders must be entered before a member or clearing member can enter orders for accounts in which they have a personal, financial, or proprietary interest.<sup>26</sup> Orders are matched according to an algorithm that gives priority to orders at the best price and orders with the same price based upon the time of entry into the system.<sup>27</sup> MGEX rules also require that any member, non-member, market participant, registered firm or large trader as defined by the CFTC, initiating or executing transactions on the Exchange must keep full, complete and systematic records of their activity for a minimum five years.<sup>28</sup>

## **2. Identification of Order Sources**

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<sup>25</sup> MGEX Rule 1807.00.

<sup>26</sup> *Id.*

<sup>27</sup> MGEX Rules 1808.00 and 1809.00.

<sup>28</sup> MGEX Rule 2009.00.

Access to the Globex system for MGEX products requires a clearing firm guarantee, and orders may be entered only through system interfaces that have been certified by CME Group.<sup>29</sup> Each person who enters an order into Globex must have a workstation operator identifier that is unique at the MGEX clearing member and identifies the individual operator.<sup>30</sup> The Exchange requires each clearing member to guarantee and assume financial responsibility for all orders it receives, places, and all contracts it clears through Globex.<sup>31</sup>

Pursuant to MGEX rules, all members and nonmembers must sign a customer account agreement and establish an account with an Exchange clearing member before they are allowed access to Globex.<sup>32</sup> Exchange rules require each participant to maintain confidentiality with respect to the operator IDs and the participant is responsible for the security of their trading terminals that access Globex.<sup>33</sup>

### **3. Identification of Operator IDs and Account Owners**

MGEX does not require the registration of Tag 50 IDs; therefore, A&I staff manually reviews cleared trade data to identify Tag 50 IDs and detect potential sharing of these IDs. After the 2009 RER, A&I staff developed a “Tag 50 Form” to obtain the operator’s identifying information, including the operator’s name, location, relationship with the MGEX clearing

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<sup>29</sup> Traders can access Globex from a variety of front-end applications that are available through CME Group, futures commission merchants (“FCMs”), introducing brokers (“IBs”), and independent software vendors (“ISVs”). Customers may connect to Globex through the Internet or through the network or data center of an FCM, IB, or ISV. Additionally, traders can connect to Globex using an electronic order routing system through iLink, the CME Group’s Globex Application Program Interface. Customers who qualify for and execute a direct access agreement with CME Group may submit their orders directly into Globex through their own direct connection.

<sup>30</sup> Each MGEX clearing member assigns a unique User ID to each person who enters orders into Globex through the iLink connection.

<sup>31</sup> MGEX Rule 1801.00.

<sup>32</sup> *Id.*

<sup>33</sup> MGEX Rule 1814.00.

member, trading software (*e.g.*, Automated Trading System or “ATS”), trading strategy, and account number(s).<sup>34</sup> A&I routinely requests that clearing members complete Tag 50 Forms for new Tag 50 IDs, Tag 50 IDs with unusual trading activity, and top market participants to detect potential operator identification violations.<sup>35</sup> During the target period, A&I opened an investigation based on its review of a Tag 50 Form that revealed possible Tag 50 ID sharing by a clearing member’s customer.<sup>36</sup> A&I’s investigation confirmed that Tag 50 IDs were periodically shared by the customer’s staff. Accordingly, A&I issued a warning letter to the customer, after the target period, for violation of MGEX Rules 1804.00 (Misuse of Electronic Trading System) and 1814.00 (System Security).

A&I also utilizes the Account Name Position Analysis Report (“ANPAR”), a market surveillance tool primarily used to monitor positions and position holders, to identify the owner and controller of an account associated with a particular order.<sup>37</sup> For accounts not identified through the Tag 50 Form process or ANPAR, A&I will often contact the clearing member that guarantees the account. The Exchange maintains that through the three methods of collecting Tag 50 ID information (*i.e.*, Tag 50 Form, ANPAR, and A&I efforts to contact clearing members) it can identify account owners responsible for approximately 78 percent of MGEX trading volume and 63 percent of MGEX Globex orders.<sup>38</sup>

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<sup>34</sup> MGEX maintains a database of the operator IDs and information obtained during the Tag 50 Form process.

<sup>35</sup> MGEX Rules 1804.00 and 1814.00. “Top market participants” are the top 10 largest market participants by trade volume at each clearing member for whom the Exchange has not yet received a Tag 50 Form.

<sup>36</sup> Investigation 11-I-14. A newly-submitted Tag 50 Form had a different name for the natural person than the form previously obtained for the same Tag 50 ID. See *infra* Section VII.D.2 for further discussion of Investigation 11-I-14.

<sup>37</sup> Each Tuesday the clearinghouse collects and creates the ANPAR from account names and numbers submitted by MGEX clearing members. The report is available on Wednesdays.

<sup>38</sup> Percentages were calculated from data spanning November 2011 to October 2012.

During the target period, A&I staff accessed MGEX Globex trade activity through FirmSoft, a CME Group Market Operations tool, to reconstruct audit trail data for electronic transactions. A&I staff use FirmSoft as part of their daily trade practice surveillance activities and the system has the capability to drill down and allow staff to go from a summary to a detailed analysis as needed. FirmSoft maintains current market data for executed trades for three trading days, and A&I staff can customize searches of historical data that is stored on the Exchange's clearinghouse system ("AS 400").

## **B. Enforcement of Electronic Audit Trail and Recordkeeping Requirements**

In the 2009 RER, the Division found that the Exchange did not conduct reviews to enforce compliance with its audit trail and recordkeeping requirements for electronic trading. Accordingly, the Division recommended that the Exchange augment its audit trail compliance program for electronic trading to include a programmatic review of electronic audit and recordkeeping rules. In response to this recommendation, the Exchange created a comprehensive, systematic program to review its clearing members' compliance with electronic audit trail requirements.

### **1. Elements of the Exchange's Electronic Audit Trail Program**

A&I conducts reviews of electronic trading recordkeeping with Firmsoft, a data analysis tool provided by the CME Group, along with proprietary modules that relate to Tag 50 IDs, CTI codes, account numbers, and record retention practices. Further, MGEX receives a daily audit data file from the CME Group called the Globex Audit Trail ("GAT") that includes all electronic trade activity and serves as the electronic audit trail.<sup>39</sup>

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<sup>39</sup> The Exchange maintains the GAT for a period of at least five years.

In addition, the Exchange developed a “Tag 50 ID Management Audit Module” in which A&I identifies and documents the clearing firm’s procedures for Tag 50 assignment as well as its record management procedures. A&I also reviews the responsibilities of parties involved in assigning Tag 50 IDs and notes the strengths of each clearing firm’s procedures, such as central databases, automated diagnostics, and preventive measures for not sharing or duplicating Tag 50 IDs internally, as well as any deficiencies. Further, A&I looks for any discrepancies or indications of shared Tag 50 IDs by examining the sample audit trail data from a single trading day, such as order entry times, session ID, order number, CTI code, origin, and account number.

To monitor and detect improper use of CTI codes and account numbers, A&I staff reviews the Unmatched Trade Report to identify CTI codes or account numbers that are unusual or subject to a high number of changes. If such instances are found, A&I contacts the clearing firm for further explanation. Additionally, A&I utilizes the daily Time Audit Report (“TAR”) and Broker Error Type Report (“BETR”) which identify invalid CTI codes where a broker, trader, or Tag 50 ID has a large number of invalid account combinations in comparison to the overall market activity (*i.e.*, number of trades and volume).<sup>40</sup>

To examine the front-end audit trail data for order routing systems and record retention practices, the Exchange developed the “Record Retention Audit Module.” In its application of the module, A&I selects sample trade data, typically one day, and verifies that data fields are present for: transaction date, product, Exchange code, expiration month, quantity, order type, order qualifier, price, buy/sell indicator, stop/trigger price, order number, unique transaction number, account number session ID, Tag 50 ID, host order number, clearing member, type of action, action status code, CTI code, origin, and timestamp. For executed trades, A&I verifies

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<sup>40</sup> See *infra* Section VI.C.2 for further description of the TAR and the BETR.



the execution trade time along with the fill information and compares the fill messages with the MGEX trade registers. A&I also confirms that the clearing firms are retaining the front-end audit trail data for five years while identifying who is responsible for record retention at the clearing firm. Through this module, A&I also ascertains the different modes of user access to the Globex platform whether it is through an ISV, proprietary software, another FCM who clears through the audited clearing firm, or direct market access. Another component of the Record Retention Audit Module is the review of the clearing firm's procedures for changes to matched trades. A&I will note any changes made in the Exchange's automated trade data entry and matching system ("TEMS") and determine the reason for the change(s) by requesting relevant documentation and/or contacting the clearing firm for an explanation.

## **2. Electronic Audit Trail Reviews**

Although the Exchange's goal is to use the Tag 50 ID Management Audit Module and the Record Retention Audit Module to conduct electronic audit trail reviews of all clearing members each calendar year, A&I did not conduct any electronic audit trail reviews during the target period. However, A&I completed an electronic audit trail review in March of 2011 ("March 2011 Review"), and initiated another electronic audit trail review in August of 2012 ("August 2012 Review"). Consequently, for purposes of this rule enforcement review, the Division evaluated the adequacy of the Exchange's March 2011 Review.<sup>41</sup>

In the March 2011 Review, A&I conducted an electronic audit trail review of all 13 of the Exchange's clearing members and identified 12 clearing members with missing electronic

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<sup>41</sup> For the March 2011 Review, A&I used both the Tag 50 ID Management Audit and the Record Retention Audit Modules to evaluate the clearing members' compliance with electronic audit trail requirements. Development and implementation of the modules, along with A&I and clearing member uncertainty concerning the electronic audit trail review process, resulted in a prolonged review of clearing members.

audit trail fields.<sup>42</sup> A&I also found eight clearing members lacking formal procedures and documentation for assigning Tag 50 IDs and monitoring them for trading abuses. The Division notes that A&I did not take disciplinary action against the clearing members regarding any of these deficiencies. Instead, A&I issued a “Report of Findings” to each of the 13 clearing members describing A&I’s findings and recommending enhancements to the clearing members’ recordkeeping systems and procedures. The Exchange explained, during the Division’s on-site interview for this review, that it carefully considered whether to take disciplinary action in response to the deficiencies found in the March 2011 Review. However, prompted by feedback from clearing firms that the Exchange’s review involved a level of detail that the firms were not accustomed to, the Exchange decided to use this first review and the Report of Findings as a tool for educating clearing members and setting expectations for future electronic audit trail reviews.

In general, the Division found the March 2011 Review to be thorough and well-documented. A&I created a file for each clearing member that included an investigation report, copies of original source documents, spreadsheets, and a copy of the Report of Findings sent to the clearing member. However, the Division is concerned that the Exchange did not conduct any follow-up reviews with the clearing members in the ensuing months after the March 2011 Review to determine whether they were meeting the expectations described by A&I in the Report of Findings. Given that the Exchange chose to defer disciplinary action for deficiencies found in the March 2011 Review, a follow-up review should have been an Exchange priority. In fact, the Exchange waited until August of 2012, or approximately 16 months after completing the

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<sup>42</sup> The common missing audit trail fields among the 12 clearing members included host order number, host trade number, session ID, unique transaction number, CTI code, and origin. Other audit trail fields missing were clearing member, exchange codes, order type, order qualifier, account number, and action status.

March 2011 Review, to initiate a new review of clearing members, and to determine whether these firms implemented A&I's recommendations.<sup>43</sup> In the Division's view, a 16-month gap between reviews diminishes the overall effectiveness of the Exchange's audit trail enforcement program. For example, disciplinary action may never escalate beyond a warning letter if reviews are not conducted at least annually because the Exchange maintains a policy that permits it to issue one warning letter per rolling 12-month period before referring the matter to the Disciplinary Committee. The Division appreciates that the Exchange revealed, during the on-site interview for this review, that it plans to, as part of its August 2012 Review, take disciplinary action against firms that have not implemented A&I's recommendations from the March 2011 Review. Nevertheless, the Division believes that an effective audit trail program must include at least annual reviews, timely follow-up reviews within six months of the preceding unsatisfactory review, and the prospect of meaningful sanctions to ensure compliance with the Exchange's electronic audit trail rules.<sup>44</sup>

### **C. Audit Trail for Open Outcry Trading<sup>45</sup>**

#### **1. Open Outcry Orders**

MGEX rules require members receiving customer orders for options trading, that are not in the form of a written record showing the account identification, order number and the date and time, to the nearest minute such order was transmitted or received, to immediately prepare a

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<sup>43</sup> The individual electronic audit trail reviews that comprise the March 2011 Review were completed on different dates from May 28, 2010 through March 11, 2011. If measured from the date the first review was completed (May 28, 2010), the Exchange waited approximately 26 months to initiate the August 2012 Review.

<sup>44</sup> The Division notes that Commission Regulation 38.553(a) of the Final DCM Rules, *supra* note 4, now requires a DCM to conduct at least annual reviews of all members, persons, and firms subject to the Exchange's recordkeeping rules to verify their compliance with the Exchange's recordkeeping requirements.

<sup>45</sup> During the target period, five members executed over 86 percent of the options traded by open outcry. In addition, open outcry options trading accounted for only 1.8 percent of the Exchange's overall volume.

written record upon receipt and include the account identification, order number, and a timestamp to reflect the date and time to the nearest minute.<sup>46</sup> The orders are written on order tickets by clearing member staff. Typically, order tickets are walked into the Exchange Room for execution by the broker.<sup>47</sup> Upon execution, the broker records the essential trade data and returns it to the clearing member where the order is timestamped again.

MGEX members record personal trades on double-sided pre-printed sequenced trading cards, with buys on one side and sells on the other.<sup>48</sup> Each trading card includes the member's name, clearing member's name, date, quantity, commodity, contract for future delivery or physical, delivery month or expiration date, price, transaction time to the minute, opposite broker or trader, opposite clearing member, and for options, premium, strike price, and a put or call indicator.<sup>49</sup> Members are required to record purchases and sales in non-erasable ink, in exact chronological order of execution, on sequential lines of the trading card without skipping lines between trades, and cross out any remaining lines on the trading card. Opening and closing periods are also required to be identified.

Trading cards are collected by clearing members within 15 minutes of each designated 30-minute interval, and clearing members submit the trade data to the MGEX clearinghouse through TEMS. TEMS enables clearing members to enter data directly from order tickets and trading cards into computer terminals located in the clearing members' offices through a virtual

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<sup>46</sup> MGEX Rule 2017.00.

<sup>47</sup> MGEX closed the trading floor in December 2008 and now has an Exchange Room where options and cash transactions are executed.

<sup>48</sup> MGEX Rule 2062.00.

<sup>49</sup> Members are required to record indicators for the following transactions: (C) cash exchange, (T) office transfer, (S) spread, and (D) delivery.

private network (“VPN”) connection to its front-end application. Transactions are required to be entered into TEMS within 45 minutes of the conclusion of each 30-minute interval.<sup>50</sup>

## **2. Trade Timing for Open Outcry Trades**

MGEX requires both the buyer and seller of each options transaction to manually record the time of each trade to the nearest minute on his or her trading card. The Exchange enforces this requirement by reviewing the TAR on a daily basis. The TAR contains time and sales data, thereby incorporating a comparison of the matched trades to the time and sales data. The purpose of this comparison is to determine whether a match could be made between the trades reported by members on their trading records and prices and times of execution reported in the time and sales data.

The TAR identifies five types of timing errors that may be indicative of a timing violation. Any discrepancies in excess of one minute automatically generate an error code on the TAR trade exception report. The five error codes are: Buyer No Trade (“BNT”),<sup>51</sup> Seller No Trade (“SNT”),<sup>52</sup> Time Out of Limits (“TOL”),<sup>53</sup> Buyer Untimed Trade (“BUT”),<sup>54</sup> and Seller Untimed Trade (“SUT”).<sup>55</sup>

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<sup>50</sup> MGEX Resolution 2101.00.C. provides that clearing members have until 3:00 p.m. to resolve any unmatched trades. Any unresolved transactions may be suspended pending possible resolution the following business day as an “as of” trade. “As of” trades can be carried no longer than one business day.

<sup>51</sup> The TAR compares the time recorded by the buyer to the time and sales data. If no trade is indicated on the time and sales at the time recorded by the buyer, or within one minute prior or one minute following that time, the trade is assigned a code of BNT.

<sup>52</sup> The computer program follows the same procedure as the BNT code but compares the seller’s recorded time to the prices recorded on the time and sales.

<sup>53</sup> The TOL error code is generated if the times recorded by both the buyer and seller are marked as accurate by the system, but there is more than one minute between the two times.

<sup>54</sup> The BUT error code is assigned to the buyer if a trade clears without a transaction time on the buy side.

<sup>55</sup> The SUT error code is generated and assigned to the seller if a trade cleared without a transaction time on the sell side.

In addition to reviewing the TAR, A&I assesses the accuracy of each member's manually recorded execution times by reviewing the BETR. The BETR is a compilation of error codes derived from the TAR and summarizes the number of errors by type for each member on a daily or monthly basis along with the cumulative total for each member for both venues, electronic and open outcry. If A&I finds a member with a trade timing error, A&I examines the underlying trade documents as well as the time and sales data to determine the "audited" error rate.<sup>56</sup> The "audited" error rate is computed by comparing a member's audited errors and total number of cleared trades on a daily basis. "Audited" errors are errors that are adjusted based on A&I's review of the cause of timing errors, such as keypunch errors by clearing member personnel, a member recording an incorrect time of execution on the original source document, or a member's illegible handwriting. Timing errors can also be attributed to a member failing to promptly report the trade to the MGEX market observer or not reporting the trade at all, as well as the market observer not recording the trade promptly or never recording the trade.<sup>57</sup> If, during A&I's daily review, the audited error rate is between five and 10 percent, the member may receive a staff warning letter. If members have audited error rates of 10 percent or more on a given day, are found to be repeatedly negligent in recording accurate times of execution, or fail to report transactions to the market observer, they may be subject to disciplinary action by the Disciplinary Committee.

The Exchange had no investigations based on timing errors during the target period.

#### **D. Exchange Room Order Tickets and Trading Cards**

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<sup>56</sup> Given the relatively low volume of open outcry trading at MGEX, daily and monthly error rate thresholds described in the 2009 RER are rarely met. As a result, A&I now reviews all open outcry trade timing errors.

<sup>57</sup> MGEX Rule 725.01. Each party to a futures or options transaction made competitively in the pit (*i.e.*, that portion of the Exchange Room designated and customarily used for trading in Futures or Options Contracts) must promptly notify the market observer(s) of the price at which the trade has been executed.

MGEX did not conduct any audit trail reviews of clearing members or brokers during the target period to evaluate compliance with the Exchange’s open outcry order ticket and recordkeeping requirements. However, the Exchange completed an audit trail review on March 2, 2011 (“2011 Exchange Room Review”), and initiated another review on July 20, 2012, more than a year after completion of the 2011 Exchange Room Review. Therefore, for purposes of this rule enforcement review, the Division assessed the adequacy of the 2011 Exchange Room Review. In the 2011 Exchange Room Review, A&I examined all of the open outcry options trading documents prepared for transactions that cleared on December 29, 2010. Specifically, A&I examined a total of 16 trading cards and seven filled order tickets from a total of seven brokers and five clearing members.<sup>58</sup> In the course of its examination, A&I found instances where four out of the seven brokers and four out of the five clearing members reviewed were not in compliance with Commission regulations or MGEX rules. In total, A&I found 18 rule violations and issued eight staff warning letters for recordkeeping and/or submission deficiencies (See Figure 4).<sup>59</sup>

**Figure 4: Summary of Results from the 2011 Exchange Room Review**

<b>Rule</b>	<b>Description of Violation</b>	<b>Number of Occurrences</b>
Commission Regulation 1.35(a)	Failure to time-stamp a customer order upon receipt to the nearest minute.	1
MGEX Rule 2062.00.F.9.	Failure to record an accurate strike price on a trading card.	4
MGEX Rule 2062.01.C.	Failure to initial a change made to a trading card after the initial time-stamp.	3

<sup>58</sup> The seven brokers and the five clearing members accounted for all transactions that cleared on December 29, 2010.

<sup>59</sup> The discrepancy between the number of rule violations (18) and the number of warning letters (eight) is the result of one broker and three clearing members receiving warning letters that cite more than one violation.

MGEX Rule 2100.00.E.	Failure to initially submit an accurate option type.	2
MGEX Rule 2100.00.E.	Failure to initially submit an accurate trade price.	2
MGEX Rule 2100.00.E.	Failure to initially submit an accurate contract month.	1
MGEX Rule 2100.00.F.	Failure to submit an accurate clearing member from a customer order.	1
MGEX Rule 2100.00.G.	Failure to initially submit an accurate transaction time to the minute.	1
MGEX Rule 2100.00.H.	Failure to initially submit accurate trade type indicators.	3
	<b>Total</b>	<b>18</b>

The Division reviewed the 2011 Exchange Room Review and found it to be well-documented and thorough with respect to the members included in the review.<sup>60</sup> The file included an investigation report, copies of original source documents, spreadsheets and other documents detailing the findings of each transaction reviewed, and copies of disciplinary letters.

Although open outcry trading accounts for a very small percentage of the Exchange's total trading volume, the Division is concerned that the Exchange's members are not maintaining a high level of compliance with the Exchange's open outcry recordkeeping requirements (four out of the seven brokers and four out of the five clearing members, collectively 67 percent of members reviewed were not in compliance). The 2011 Exchange Room Review indicates that the Exchange's open outcry order ticket and recordkeeping requirements are generally not being rigorously observed by the Exchange's brokers and clearing members. The Division believes

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<sup>60</sup> The Division identified an additional five brokers and six clearing members that executed and cleared trades in 2010 that were not reviewed by the Exchange. Commission Regulation 38.553(a) of the Final DCM Rules, *supra* note 4, now requires a DCM to conduct at least annual reviews of all members, persons, and firms subject to the Exchange's recordkeeping rules to verify their compliance with the Exchange's recordkeeping requirements. Therefore, in order to comply with Commission Regulation 38.553(a), the Exchange must broaden the scope of future open outcry recordkeeping reviews to include all members, persons, and firms subject to the Exchange's recordkeeping rules.



that the low level of compliance may be attributed to the infrequency of open outcry recordkeeping reviews and, consequently, the unlikely prospect of any sanctions.<sup>61</sup> Although the Exchange found numerous recordkeeping deficiencies in the 2011 Exchange Room Review, A&I waited approximately 15 months to initiate a new review of open outcry recordkeeping. Given that audit trail violations can be indicative of substantive trading violations, the Division believes open outcry audit trail reviews should be conducted no less than annually.<sup>62</sup> In the event that members are not maintaining a high level of compliance, the Division believes that the Exchange should conduct timely follow-up reviews within six months of the preceding unsatisfactory review to ensure the presence and accuracy of open outcry audit trail records. The Division recognizes such reviews may appear overly burdensome given the low volume of open outcry trading. However, low open outcry volume should result in a correspondingly low number of open outcry records for the Exchange to review. In addition, the Exchange should take appropriate disciplinary action where low levels of compliance persist to deter recidivist activity and ensure compliance with the Exchange rules.

#### **E. Summary Fines for Inaccurate and/or Late Submissions**

As discussed above, when A&I conducts electronic or open outcry audit trail reviews, it routinely requests information from market participants (*e.g.*, Tag 50 Forms, trading cards, and order tickets). In order to ensure the timely receipt and accuracy of requested information,

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<sup>61</sup> Commission Regulation 38.553(b) of the Final DCM Rules, *supra* note 4, now requires, in part, that a DCM's enforcement program identify members subject to the DCM's recordkeeping rules that have failed to maintain high levels of compliance with such requirements and levy meaningful sanctions when deficiencies are found.

<sup>62</sup> Prior to the requirement in Final DCM Rule 38.553(a) that a DCM conduct at least annual audit trail reviews (and prior to the target period and the 2011 Exchange Room Review), the Division conveyed its view of the necessity for annual open outcry audit trail reviews. Specifically, in a rule enforcement review of another exchange in 2010, the Division recommended that "open outcry saturation audit trail reviews should be conducted no less than annually." *See* CFTC, Div. of Mkt. Oversight, Rule Enforcement Review of ICE Futures U.S (Feb. 2, 2010) at 27, 31, and 32, available at <http://www.cftc.gov/ucm/groups/public/@iodcms/documents/file/rericefutures020210.pdf>.

MGEX Rule 2069.00 (Reporting Requirements and Sanctions) authorizes A&I to summarily fine market participants for the “inaccurate, incomplete or untimely submission of data, records or information submitted to the Exchange.”<sup>63</sup> Although Rule 2069.00 includes a summary fine ceiling of \$5,000 per offense for individuals and \$10,000 per offense for firms and corporations, the Division is concerned that the Exchange’s rulebook does not include the summary fine schedule for Rule 2069.00 violations. Instead, this information is contained in an internal document maintained by A&I that is separate from the Exchange’s rulebook. The Division believes that if the Exchange wishes to maintain rules that authorize the issuance of summary fines, the Exchange’s rulebook should also contain a corresponding summary fine schedule.<sup>64</sup> Incorporating the summary fine schedule into the Exchange’s rulebook will, among other things, provide greater transparency to the Commission, market participants, and the public. Moreover, after reviewing the summary fine schedule, the Division is concerned that the Exchange’s present summary fine amounts may be low enough that market participants could view them as merely a cost of doing business, and that the fines could therefore fail to sufficiently deter information submission violations on an ongoing basis. The Division believes that higher summary fine amounts, including an initial summary fine amount of at least \$1,000, would be a greater deterrent, and thus would serve to maintain high rates of information submission compliance.<sup>65</sup>

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<sup>63</sup> There were no summary fines issued during the target period.

<sup>64</sup> The addition of a summary fine schedule to the Exchange’s rulebook would constitute a rule filing subject to approval by the Commission or the Commission’s self-certification procedures. CEA § 5c(c); 17 C.F.R. §§ 40.5, 40.6.

<sup>65</sup> Prior to the target period, the Division conveyed its view that an initial summary fine amount should be at least \$1,000. Specifically, in a joint rule enforcement review of the CBOT and the Chicago Mercantile Exchange in 2010, the Division recommended that the exchanges “adopt a revised summary fine schedule providing for fine amounts that are clearly sufficient to deter open outcry recordkeeping offenses, beginning with an initial summary fine amount of at least \$1,000.” *See* CFTC, Div. of Mkt. Oversight, Rule Enforcement Review of the Chicago

## **F. Safe Storage Capability**

Commission Regulation 1.31 governs the manner in which an exchange is required to maintain trade-related records. The regulation mandates that all records required to be kept under the Act or Commission regulations be maintained for five years and be readily accessible during the first two years. Acceptable methods of record retention include electronic storage media for both the two and five year periods.

The Exchange maintains the audit trail data on redundant production systems, at an off-site storage facility and at a separate off-site disaster recovery facility. MGEX can access complete audit trail data for both electronic and open outcry trading on the AS 400, which is located at the Exchange's headquarters.<sup>66</sup> The Exchange has a redundant back-up server, located in the Exchange's north building, which stores data simultaneously. The Exchange also copies the audit trail data onto back-up tape cartridges daily and stores them at a Minneapolis-based vendor of off-site storage.<sup>67</sup> Archived data for electronic and open outcry data are stored for a minimum of five years at the off-site facility. MGEX also stores some trade data in hard copy form, for a minimum of five years, in a vault in the Exchange building.<sup>68</sup>

Lastly, MGEX instantaneously transmits audit trail data for electronic and open outcry trading from its production systems to a disaster recovery facility over a dedicated VPN connection. Furthermore, all Globex messages are transmitted directly and simultaneously to the

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Board of Trade and the Chicago Mercantile Exchange (Sept. 13, 2010) at 5 and 52-53, *available at* [http://www.cftc.gov/ucm/groups/public/@iodcms/documents/file/rrcbot\\_cme091310.pdf](http://www.cftc.gov/ucm/groups/public/@iodcms/documents/file/rrcbot_cme091310.pdf).

<sup>66</sup> Daily copies of TAR, time and sales, and TEMS clearing data are stored on the AS 400 production server, a back-up server located at MGEX headquarters, and the back-up tape storage facility.

<sup>67</sup> Up to 10 years of trade data are stored at this facility.

<sup>68</sup> A&I maintains the hard copy trade data at MGEX headquarters for approximately two months before it is transferred to the vault.

Exchange's redundant servers through the VPN connection and to the disaster recovery site through a point-to-point connection. Both the Exchange's system and the disaster recovery site are mirror images of each other and reflect the changes made to the Exchange's production system instantly. The disaster recovery facility is located a significant distance from MGEX headquarters.

## **G. Conclusions and Recommendations**

The Division found that MGEX maintains a complete electronic record of all orders entered and all transactions executed, including the terms and time of entry for each order, all order modifications/cancellations, and all matched trades. The record enables MGEX to reconstruct electronic trading efficiently and effectively. Moreover, since the 2009 RER, MGEX has developed a comprehensive systematic review program for electronic audit and recordkeeping requirements. However, the Exchange did not conduct reviews annually, nor did it follow-up with clearing members to determine whether they addressed the deficiencies found in the March 2011 Review. The Division believes that an effective audit trail program must include at least annual reviews, timely follow-up reviews within six months of the preceding unsatisfactory review, and the prospect of meaningful sanctions to ensure compliance with the Exchange's electronic audit trail rules.

The Division found that MGEX generally has adequate procedures for monitoring compliance with open outcry recordkeeping requirements through routine audit trail reviews that enable the detection and sanctioning of recordkeeping violations. However, the Division has concerns regarding two elements of the Exchange's open outcry audit trail program. First, while the Exchange does have a program for monitoring compliance with open outcry recordkeeping requirements, it did not conduct an audit trail review for approximately 15 months. Second,

MGEX's 2011 Exchange Room Review revealed that Exchange members did not maintain a high level of compliance with open outcry order ticket and recordkeeping requirements. The Division believes that the infrequency of open outcry recordkeeping reviews may be a contributing factor to the low level of compliance. Accordingly, the Division believes that the Exchange should conduct open outcry audit trail and recordkeeping reviews at least annually and, where members fail to maintain a high level of compliance, conduct timely follow-up reviews within six months of the preceding unsatisfactory review and take appropriate disciplinary action.

The Exchange's summary fine schedule for Rule 2069.00 violations, as discussed above, is not publicly available and provides for an initial summary fine amount that is less than \$1,000. The Division believes that if the Exchange wishes to maintain rules that authorize the issuance of summary fines, the Exchange's rulebook should contain a corresponding summary fine schedule. The Division also believes that incorporating the summary fine schedule into the Exchange's rulebook will, among other things, provide greater transparency to the Commission, market participants, and the public. The Division is also concerned that summary fine amounts in the current schedule may be low enough that market participants could view them as merely a cost of doing business, and that they therefore could fail to sufficiently deter recordkeeping violations on an ongoing basis. Accordingly, the Division believes that the Exchange should revise the summary fine schedule to provide for fine amounts that are clearly sufficient to deter information submission offenses, beginning with an initial summary fine amount of at least \$1,000.

The Division found that MGEX has adequate safe storage capability for its trade data. The Exchange retains five years' worth of open outcry trade data in both computerized and hard copy form, and five years' worth of electronic trading data. Both open outcry and electronic data

are stored on-site, off-site, and maintained at a disaster recovery site a significant distance from MGEX headquarters.

Based on the foregoing, the Division recommends that:

- **The Exchange conduct electronic and open outcry audit trail and recordkeeping reviews at least annually, as well as timely follow-up reviews within six months when the Exchange finds members who fail to maintain a high level of compliance with Exchange rules.**
- **The Exchange publish its summary fine schedule in the Exchange rulebook and revise its summary fine schedule to provide for fine amounts that are clearly sufficient to deter information submission offenses, beginning with an initial summary fine amount of at least \$1,000.**

## **VII. TRADE PRACTICE SURVEILLANCE PROGRAM**

### **Pre-Amendment of the CEA by the Dodd-Frank Act**

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

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

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

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

### **Post-Amendment of the CEA by the Dodd-Frank Act**

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

- A. *In general.* —The board of trade shall establish, monitor, and enforce compliance with the rules of the contract market, including —**
- i. access requirements;**
  - ii. the terms and conditions of any contracts to be traded on the contract market; and**
  - iii. rules prohibiting abusive trade practices on the contract market.**

- B. *Capacity of contract market.* —The board of trade shall have the capacity to detect, investigate, and apply appropriate sanctions to any person that violates any rule of the contract market.**
- C. *Requirement of rules.* —The rules of the contract market shall provide the board of trade with the ability and authority to obtain any necessary information to perform any function described in this subsection, including the capacity to carry out such international information-sharing agreements as the Commission may require.**

**Core Principle 12 – Protection of Markets and Market Participants:**

**The board of trade shall establish and enforce rules —**

- A. to protect markets and market participants from abusive practices committed by any party, including abusive practices committed by a party acting as an agent for a participant; and**
- B. to promote fair and equitable trading on the contract market.**

During the entirety of the target period, the acceptable practices set forth in Appendix B to Part 38 of the Commission’s regulations provided that a contract market’s trade practice surveillance program should have the arrangements, resources, and authority necessary to perform effective rule enforcement.<sup>69</sup> 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 contact market itself or through delegation to a third party.

An acceptable trade practice surveillance 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

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<sup>69</sup> See discussion of applicable guidance and acceptable practices *supra* note 4.

authority to discipline, suspend, or terminate the activities of members or market participants pursuant to clear and fair standards.<sup>70</sup>

#### **A. Staffing and Trade Practice Duties**

As discussed above in Section V, A&I staff consists of four investigators with varying levels of experience who are responsible for, among other things, conducting daily trade practice surveillance and investigations. The investigators report to the CRO who reviews and approves the opening and closing of investigations, and the Chief of Staff who manages staffing resources for effective and timely execution of the Exchange's trade practice program.

All investigators are involved in the two principal tasks of the trade practice surveillance program, namely "daily surveillance" and trade practice "investigations." Daily surveillance responsibilities are rotated among the four investigators every two days and consists of regular review of trade data, exception and statistical reports, and the use of computerized surveillance tools to detect patterns of trading activity that could indicate possible trading violations and warrant further review.<sup>71</sup>

Each investigator also participates in investigations. Investigations are initiated, with the CRO's approval, whenever daily surveillance, a customer or trader complaint, or a Commission referral indicates the possibility of a violation of Exchange rules or of the Act or Commission regulations.

The senior investigator has additional responsibilities of working with MOG staff to develop, test, and implement enhancements to the Exchange's automated trade surveillance

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<sup>70</sup> See *infra* Section VIII for discussion of the aspect of Core Principle 2 that relates to the disciplining of members who violate Exchange rules. 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.

<sup>71</sup> Market surveillance, another daily surveillance responsibility, includes the monitoring of cash and futures prices, spread and basis relationships, size and ownership of deliverable supply, and size of large trader positions relative to total open interest and deliverable supply. Market surveillance was not a subject of this RER.



system which are described below. Another staff investigator performs financial surveillance in addition to daily surveillance and investigations.<sup>72</sup>

## **B. Automated Surveillance**

During the target period, the TAR and BETR served together as the Exchange's automated trade practice surveillance system for identification of possible trade practice violations for electronic and open outcry trading.<sup>73</sup> The TAR combines the details of all futures and options trades in chronological order with Exchange time and sales data. The options open outcry trades are listed separately from trades executed on the electronic platform. The TAR generates error codes based on preset parameters that identify possible substantive trade practice abuses, such as wash trading or trading ahead.<sup>74</sup> The system also identifies cross trades, which are referred to as "ring trades" at the Exchange.<sup>75</sup> On a daily basis, A&I staff reviews the error codes generated by the TAR as well as the BETR to look for patterns of exceptions concerning

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<sup>72</sup> Financial surveillance entails the review of daily pays and collects of clearing members to MGEX and other DCOs and monthly financial statements.

<sup>73</sup> MGEX produces supplemental reports from the TAR, such as the Broker vs. Broker Summary Report, Broker vs. Clearing Member Summary Report, Unmatched Trade Report, and Broker Inquiry Report, to assist A&I staff with reviewing data and exceptions identified during the daily surveillance.

<sup>74</sup> The TAR generates error codes identifying potential instances of the following along with the applicable error codes: accommodation trading ("ACC"), buyer or seller trading ahead ("BTA" or "STA"), invalid CTI ("CTI"), invalid ring trade ("IRG"), invalid spread ("ISP"), money pass ("MPS"), no summary record ("NSR"), price above daily high ("PAH"), price below daily low ("PBL"), and wash trading ("WSH"). Error codes identified for trading on side-by-side venues are: cross buyer or cross seller trading ahead ("CBA" or "CSA"), cross accommodation trading ("CAC"), cross money through ("CMP"), and cross wash ("CWS"). The cross error codes enable A&I staff to compare trading activity on the open outcry platform to the trading activity on the electronic platform to detect potential trade practice violations across the two venues. These error codes apply only to options since all futures trade exclusively on Globex.

<sup>75</sup> A&I verifies ring trades by reviewing the written record that is completed and signed by the market observer at the time of the open outcry trade as required by MGEX Rule 2019.00 (Official Representative to Observe the Execution of Buying and Selling Orders at the Same Price). MGEX Rule 742.00 (Cross Trading - Handling Both Buying and Selling Orders) describes the process a member must follow for crossing buy and sell orders of different principals by open outcry.

individual traders.<sup>76</sup> Throughout the target period A&I staff also utilized Globex applications, FirmSoft and the Networked Exchange Monitoring System (“NEMO”), to access all order data on a real-time or ad-hoc basis for analyzing the exceptions identified on the TAR and BETR in more detail.<sup>77</sup>

Since the 2009 RER, the Exchange has enhanced the automated tools used by A&I investigators to conduct trade practice surveillance and investigations.<sup>78</sup> Specifically, the Exchange has added four exception reports and one informational report: the Settlement Manipulation Exception Report, the Fast Fills Exception Report, the CTI Account Exception Report, the Broker Error Exceptions Report, and the Message Summary Report. The Settlement Manipulation Exception Report provides a general toolkit for analyzing market activity throughout the day but with a primary focus on the closing period.<sup>79</sup> The Fast Fills Exception Report allows investigators to conduct time and price analysis against Globex trades to identify situations where a market participant in a particular instrument executes quickly offsetting trades

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<sup>76</sup> For BTA, STA, ACC, MPS, WSH, IRG, ISP, and CTI codes, A&I may open an investigation when a market participant has a monthly error rate of 10 percent or greater in a contract. A&I does not have minimum percentage thresholds for other exceptions but rather determines whether to open an investigation on a case-by-case basis.

<sup>77</sup> FirmSoft is a browser-based order management tool that provides real-time access to working and filled Globex (MGEX) orders. A&I staff can view and save relevant order information, such as: Entry Time, Fill Time, Contract Month, Strategy Type, and Order Number. NEMO provides access to the order data of the current trading session and the past three weeks and is used to get detailed information about a specific order or market activity in a defined time range. After the target period the Exchange indicated that it stopped using NEMO. Instead, the Exchange now relies exclusively on Firmsoft and the GAT to access order data. See *supra* Section VI.B.1 for further discussion of Firmsoft and the GAT.

<sup>78</sup> The Exchange formally implemented the new automated surveillance functionality on August 13, 2012, after the target period and in conjunction with the launch of the apple juice concentrate contract. The Division notes that Commission Regulation 38.156 of the Final DCM Rules, *supra* note 4, now requires a DCM to maintain an automated trade surveillance system capable of detecting and investigating potential trade practice violations.

<sup>79</sup> The report has five sections including: closing statistics (*e.g.*, volume, trades, new orders, order modifications and cancels by instrument and side during a specified time range); market depth and price anomalies through visualization tools; trader summary information at selected aggregation levels (instrument, account, and side); position summary of the daily net activity to the overall activity on the day by trader ID/Tag 50; and Tag 50-level details with a scatterplot visualization overlay of a specific market participant against the entire market depth, differentiating sides and orders versus the overall market.

at an equal or worse price for the customer. The CTI Account Exception Report captures trades clearing with the same account number on both sides of a transaction. The Broker Error Exceptions Report captures market participants with error exceptions that total 10 percent or more of their cleared trade volume. This report includes all market participants with timing errors and trading ahead exceptions but does not include CTI code exceptions. The Message Summary Report is an informational report that provides a summary of order and fill activity for Globex trading by trader ID and Tag 50 ID, as well as a ratio of fill to non-fill messages. This report aids staff investigators in identifying the different trading strategies employed by market participants as they review the daily exceptions and conduct investigations. An immediate benefit of the enhanced automated surveillance tools is A&I staff's ability to retrieve and query transactional data with embedded graphical functionality through a web-based application instead of using separate systems to view multiple reports.

### **C. Exchange Room Surveillance of Open Outcry Trading**

Staff investigators conduct Exchange Room surveillance primarily during the openings and closings of all options contracts but also randomly observe trading activity at A&I staff's discretion should market conditions warrant.<sup>80</sup> One staff investigator is present in the Exchange Room five to 10 minutes prior to the open and remains at the Exchange Room 10 minutes after the open. At the close, a staff investigator is present for approximately 15 minutes. When conducting surveillance in the Exchange Room, the staff investigator observes price movements and monitors, among other things, trades executed prior to the opening or after the close, disclosure of orders, illegally executed ring (cross) trades, noncompetitive trading, improper

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<sup>80</sup> MGEX closed the trading floor in December 2008 and now has an Exchange Room where options and cash transactions are executed. During the target period, staff investigators were present for the openings and closings; no random times were observed.

bidding or offering, and transactions not executed by open outcry. Staff investigators also take into consideration account rules governing trading activities, such as the execution of ring trades, simultaneous purchases and sales, and spread transactions.

A&I documents Exchange Room surveillance in the “pit population log” after each visit to the Exchange Room. The pit population log lists the date and time period Exchange Room surveillance was conducted, the number of brokers, observations of trades executed between brokers, and comments about current market activity. The pit population log can be used to verify who was in the Exchange Room at the time of a particular trade. During the target period, staff investigators did not observe any potential rule violations while observing open outcry trading in the Exchange Room.

#### **D. Trade Practice Investigations**

##### **1. Initiation of Investigations**

Pursuant to the guidelines in the Exchange’s Compliance Manual, A&I staff investigators open a formal investigation into instances of potential trade practice violations whenever an initial staff review of exception reports, an analysis of trade data, or an Exchange Room observation indicate that an investigation is warranted.<sup>81</sup> Investigations are also opened for all customer or member complaints and all Commission referrals.

As part of every investigation, A&I reviews all trades of the party or parties involved for a selected review period. Copies of all trade documents along with the TAR are maintained in the investigation file. Notations regarding document requests and a summary of the analysis are documented in close proximity to the flagged trades on the TAR. At the conclusion of an

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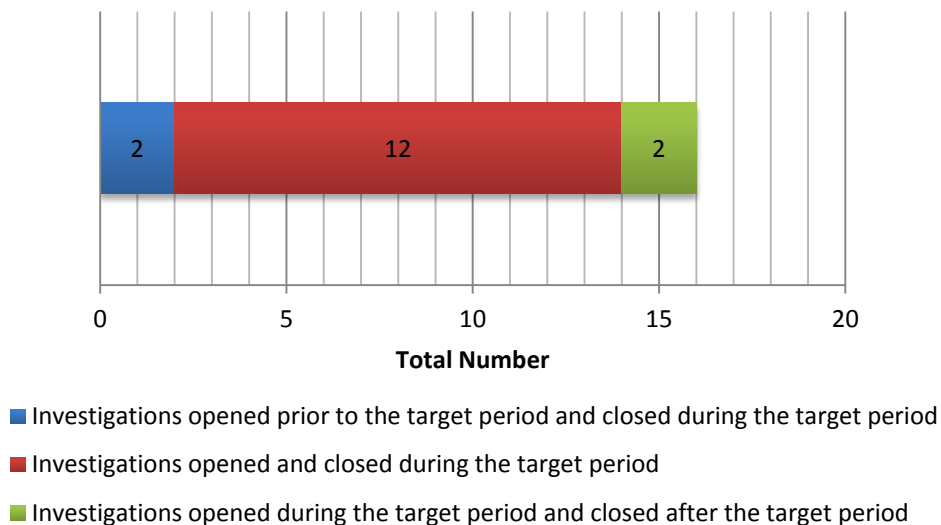
<sup>81</sup> A&I no longer maintains an inquiry level of review for exceptions or any other type of potential rule violation. As mentioned above, A&I staff open formal investigations, after the CRO’s approval, whenever daily surveillance, a customer or trader complaint, or a Commission referral indicates the possibility of a violation of Exchange rules or of the Act or Commission regulations.

investigation, A&I prepares an investigation report detailing the steps taken during the investigation and the reasons for A&I's determination concerning what action, if any, should be taken.

## 2. Adequacy of Investigations

As illustrated in Figure 5 below, during the target period, the Exchange closed 14 trade practice investigations, including two opened prior to the target period and 12 opened during the target period. In addition, after the target period, the Exchange closed the two remaining investigations that were opened during the target period. The Division thoroughly reviewed all 16 closed investigations for adequacy, documentation, and timeliness.

**Figure 5: Sixteen Investigations Opened and/or Closed During the Target Period**



Each of the files included an A&I cover sheet that provided a brief summary of events and an investigation checklist. The purpose of the A&I cover sheet is to summarize the various documents in the investigation file and to inform the reader of the status of the investigation. The A&I cover sheet includes, among other things, the dates when the investigation was opened and closed, the alleged violations cited, the market participant, member and/or member clearing

firm under investigation, the source of the investigation, requests for documents, issuance of interview notices, violations cited, referral to a disciplinary committee, and any final action taken. Similarly, the purpose of the investigation checklist is to assist in the accurate, thorough and timely completion of an investigation.

The files also included copies of the TAR, time and sales data, copies of trade documents, copies of computer-generated reports, trade data analysis, summary of trading activity, work papers, interview notices and summaries, copies of relevant correspondence including emails, past disciplinary history, and copies of disciplinary letters. At the close of each investigation, A&I staff prepared an investigation report which detailed the source of the investigation, analysis, findings of facts discovered during the investigation, conclusions, and recommendation(s).

Of the 16 closed investigations, 15 were generated based upon reviews of exceptions identified on the TAR or the BETR and one resulted from the review of a Tag 50 Form.<sup>82</sup> Fourteen of the closed investigations were closed with no action, one investigation resulted in a fine, and another investigation resulted in a warning letter. Investigation 11-I-09, which resulted in a fine, involved two traders who engaged in a series of prearranged, non-competitive wash trades in HRSW futures contracts.<sup>83</sup> Investigation 11-I-14, which resulted in a warning letter, involved the sharing of Tag 50 IDs.<sup>84</sup>

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<sup>82</sup> Of the 16 closed investigations, 15 involved electronic trading and one involved open outcry trading.

<sup>83</sup> See *infra* Section VIII.B for further discussion of Investigation 11-I-09.

<sup>84</sup> In Investigation 11-I-14, a Tag 50 Form submitted by the subject on July 13, 2011 conflicted with previously obtained Tag 50 information. A&I found that Tag 50 IDs were being shared and issued a warning letter for apparent violations of MGEX Rules 1804.00 (Misuse of Electronic Trading System) and 1814.00 (System Security). Investigation 11-I-14 was closed after the target period.

The Division thoroughly reviewed all 16 closed investigations and identified two areas of concern. First, the Division found that 13 investigations were too narrow in their scope, consisting of a review of a single trading day.<sup>85</sup> The 13 investigations arose from money pass, wash trading, trading ahead, invalid ring, and/or accommodation exceptions. According to investigation files, in each of the 13 investigations, A&I characterized the trading behavior of the subject trader based on an analysis of reference documents and a single day of trading activity.<sup>86</sup> It appears that A&I did not expand its analysis beyond the date of each identified exception to look for possible patterns of trading abuse by the subject or opposite trader. The Division believes that the scope of all trade practice investigations should be broadened beyond a single trading day in order to look for potential patterns of trading abuse.<sup>87</sup>

The second area of concern includes seven investigations for which the Division believes A&I did not fully conduct and/or document its analysis.<sup>88</sup> For example, in Investigation 11-I-10, which arose from invalid ring trade exceptions on May 17, 2011, A&I identified an instance where the subject entered orders for two customer accounts and his personal account, which were all filled opposite a customer give-up account. A&I concluded that the subject entered the customer orders before his personal trades and thus did not trade ahead of his customers. A&I also concluded that the trades between the two customer accounts and the customer give-up

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<sup>85</sup> In closed Investigation 12-I-10, the subject's trading activity was examined for three days, March 12–14, 2012. In two investigations closed after the target period, Investigations 11-I-14 and 12-I-14, A&I expanded the scope of its review to include August 2011 through April 2012 and May 7-11, 2012, respectively.

<sup>86</sup> Reference documents include Tag 50 Forms, trader profiles, and analysis of order messages.

<sup>87</sup> During the Division's on-site interview, Exchange staff acknowledged that future investigations will be expanded beyond the date of the identified exception in order to seek possible patterns of trading abuse by the subject or opposite trader.

<sup>88</sup> Three of the seven investigations each contain two instances of A&I not fully conducting and/or documenting its analysis.

account did not demonstrate an intentional attempt to trade opposite each other. However, to arrive at this conclusion, A&I determined that the customer and personal orders had “sufficient market exposure,” but did not document the amount of exposure given in relation to existing market conditions.<sup>89</sup> MGEX rules are silent on specific time thresholds for exposing customer orders to the marketplace, and A&I determines “sufficient market exposure” on a case-by-case basis. As a result, the Division believes that A&I should fully document its “sufficient market exposure” analysis in investigation reports when applicable.

The Division found that one investigation was deficient because A&I did not review and/or document the reason for a post-execution account change. In Investigation 11-I-11, A&I identified an instance, while reviewing trading ahead exceptions, where the subject trader changed a filled trade from his personal account to a customer account. With respect to the trading ahead exceptions, A&I concluded that the subject entered the customer orders before his personal trades and thus did not trade ahead of his customers. However, despite mentioning the account change in the investigation report, A&I did not provide an explanation for the account change or provide any supporting records/documentation in the investigation file. The Division believes A&I should have reviewed the customer’s original order to confirm that the customer received the best possible price available at that time and ascertained the reason for the account change. Such review may have revealed that the broker allocated a trade to the customer’s detriment.

The Division found that three investigations were deficient because A&I did not determine profit and loss as part of analyzing the subjects’ intent. Specifically, three investigations, arising from accommodation and/or money pass exceptions, were closed without

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<sup>89</sup> Similarly, in closed Investigations 12-I-02, 12-I-05, 12-I-09, 12-I-10, and 12-I-11, A&I determined market exposure times were sufficient, but did not describe the exposure time in relation to market conditions.



action after A&I determined that the subjects had not intentionally entered into risk-free transactions to accommodate trades or pass money. However, in arriving at its findings regarding the subjects' intent, A&I did not calculate or consider the profit and loss of the subjects' trades at issue.<sup>90</sup> Profit and loss calculations can reveal intent where traders or accounts consistently make or lose money on trades identified by accommodation or money pass exceptions. Therefore, the Division believes A&I, in its evaluation of these potential accommodation and money pass rule violations, should have calculated profit and loss in order to make a thorough evaluation of the subjects' intent. Given the concerns expressed above regarding incomplete analysis and/or inconsistent documentation, the Division recommends that the Exchange take appropriate measures to ensure that trade practice investigations are consistently thorough and well-documented.

### **3. Timeliness of Investigations**

Fifteen of the 16 closed investigations were completed in six months or less and none were open for longer than one year.<sup>91</sup> However, Investigation 11-I-14, which was opened during the target period but closed subsequently, was open for 360 days.<sup>92</sup> During the Division's on-site interview, A&I staff explained, and the investigation report confirmed, that the investigation was kept open to ensure the subject was no longer sharing Tag 50 IDs as A&I directed. The Division recognizes A&I's efforts to monitor and follow-up on this matter and believes that, given the circumstances, Investigation 11-I-14 was not open for an excessively long period.

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<sup>90</sup> Profit and loss were not calculated in Investigations 12-I-02, 12-I-09, and 12-I-10. Profit and loss were calculated in Investigation 12-I-04 which involved a trader who unintentionally crossed buy and sell orders for his personal account on Globex and Investigation 12-I-06 which involved a trader whose spread trading strategy generated possible accommodation, wash, and invalid ring trade exceptions.

<sup>91</sup> In early 2013, the Exchange amended its Compliance Manual to require the completion of investigations no later than 12 months after the date that the investigation is opened.

<sup>92</sup> See *supra* Section VII.D.2 for further description of Investigation 11-I-14.

## **E. Conclusions and Recommendations**

The Division found that MGEX generally maintains an adequate trade practice surveillance program administered by A&I staff investigators with varying levels of experience. Staff investigators reviewed the TAR and BETR to identify possible trade practice violations in electronic and open outcry trading. A&I conducted daily Exchange Room surveillance of open outcry option trading during the open and close. The Exchange has enhanced its automated trade practice surveillance system with a web-based application that integrates new and existing reports.

The Division found two areas of concern among the 16 closed investigations. First, in 13 investigations A&I examined only one trading day and did not expand the scope of its analysis to look further for patterns of abuse by the subject or opposite trader.<sup>93</sup> The second area of concern includes seven investigations for which the Division believes A&I did not fully conduct and/or document its analysis. Some of these investigations involve more than one instance where A&I did not fully conduct and/or document its analysis. In six investigations, A&I determined that orders had “sufficient market exposure,” but did not describe the amount of exposure given in relation to existing market conditions. In one investigation, A&I did not review the customer’s original order and explain or document why the subject changed a filled trade from his personal account to a customer account. Finally, in three investigations, A&I did not calculate profit and loss for the subjects’ trades at issue in order to make a thorough evaluation of the subjects’ intent. Accordingly, the Division believes the Exchange should take

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<sup>93</sup> The Division notes that it made a recommendation regarding the scope of MGEX investigations in its 2004 rule enforcement review of MGEX. Specifically, the Division recommended that the Exchange “expand the scope of its investigations to include additional trading dates when review of exception reports suggests the possibility of trading violations.” See CFTC, Div. of Mkt. Oversight, Rule Enforcement Review of Minneapolis Grain Exchange at 29 (Sept. 16, 2004), *available at* <http://www.cftc.gov/files/tm/tmmgexfinal091604.pdf>.

appropriate measures to ensure that trade practice investigations are consistently thorough and well-documented.

Lastly, the Division found that all 16 closed investigations were closed within a reasonable length of time.

Based on the foregoing, the Division recommends that:

- **The Exchange take the following measures to ensure that trade practice investigations are consistently thorough and well-documented:**
  1. **Expand the scope of Exchange investigations to include additional trading dates in order to identify possible patterns of trade practice violations;**
  2. **Analyze and document order exposure times in relation to existing market conditions when determining the sufficiency of market exposure;**
  3. **Review underlying orders and the reasons for account changes in investigations where there is a post-execution account change involving customer and trader accounts; and**
  4. **Calculate profit and loss in order to thoroughly evaluate the subject's intent when investigating potential trade practice rule violations, including, but not limited to, accommodation and/or money pass exceptions.**

## **VIII. DISCIPLINARY PROGRAM**

### **Pre-Amendment of the CEA by the Dodd-Frank Act**

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

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

### **Post-Amendment of the CEA by the Dodd-Frank Act**

#### **Core Principle 13 – Disciplinary Procedures:**

**The board of trade shall establish and enforce disciplinary procedures that authorize the board of trade to discipline, suspend, or expel members or market**

**participants that violate the rules of the board of trade, or similar methods for performing the same functions, including delegation of the functions to third parties.**

Core Principle 13 requires boards of trade to “establish and enforce disciplinary procedures that authorize the board of trade to discipline, suspend, or expel members or market participants that violate the rules of the board of trade...” Disciplinary actions must be prompt and conducted pursuant to clear and fair standards.<sup>94</sup>

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

During the target period, the Exchange maintained two disciplinary committees, the Futures Trading Conduct Committee (“FTCC”) and the Business Conduct Committee (“BCC”). The FTCC had jurisdiction over matters concerning futures and option trading, including consideration of possible trading violations, while the BCC had jurisdiction over all other potential violations, such as registration issues, clearinghouse matters, position limits and margins.<sup>95</sup> In October 2012, the Exchange amended its disciplinary rules and consolidated the FTCC and BCC into a single disciplinary committee (“Disciplinary Committee”) with jurisdiction over all disciplinary matters. The Disciplinary Committee’s primary function is to review investigations and determine whether rule violations may have occurred.

The Disciplinary Committee consists of five members, including the Exchange President, a member of the Board appointed by the President, two Exchange members, and a person who qualifies as a “public director” appointed by the Board.<sup>96</sup> No person is permitted to serve as a

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<sup>94</sup> See discussion of applicable guidance and acceptable practices *supra* note 4.

<sup>95</sup> Both disciplinary committees also had the authority to hold hearings on contested charges and function as a hearing committee.

<sup>96</sup> MGEX Rule 264.00. Chapter 1 of the Exchange’s rulebook defines a public director as “an individual meeting the qualifications as described in Core Principle 15 [now Core Principle 16 pursuant to the Dodd-Frank Act], Appendix B to Part 38 of CFTC Regulations and in other Regulations promulgated by the CFTC and adopted by the Board.”

member of the Disciplinary Committee if the person, or firm with which the person is affiliated, has a financial, personal or prejudicial interest or concern in the matter before the Disciplinary Committee.<sup>97</sup> Also, persons who have participated in or been involved in adjudicating any other stage of the same proceeding are prohibited from serving on the Disciplinary Committee.<sup>98</sup>

At the conclusion of an A&I investigation, the CRO determines whether to close the matter without action, issue a staff warning letter, or refer the matter to the Disciplinary Committee.<sup>99</sup> Upon receipt of an A&I investigation report, the Disciplinary Committee may authorize the issuance of a Notice of Charges, direct A&I to gather additional information, or determine that charges in the investigation report are without reasonable foundation in fact.<sup>100</sup> If the Disciplinary Committee finds that a violation may have occurred, the respondent named in the investigation report will receive a Notice of Charges setting forth the alleged violation and the Exchange rules believed to have been violated. The Notice of Charges also advises the respondent of his or her right to a hearing and prescribes the period within which an answer must be filed and a hearing on the charges may be requested.<sup>101</sup> Failure to request a hearing within the period set forth in the Notice of Charges may be deemed a waiver of the right to a hearing. Any allegation that is not specifically denied in the respondent's answer may be deemed admitted by

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<sup>97</sup> MGEX Rule 264.01.

<sup>98</sup> *Id.*

<sup>99</sup> All staff warning letters are recorded in investigation files, and become part of the recipients' disciplinary histories. The Exchange has a policy of issuing no more than one warning letter per rolling 12-month period before referring the matter to the Disciplinary Committee. MGEX also maintains summary fine schedules that allow A&I to fine market participants for violations related to recordkeeping, decorum, or other similar rules, without the matter being referred to the Disciplinary Committee.

<sup>100</sup> MGEX Rule 264.03.

<sup>101</sup> MGEX Rule 603.00 states that the Disciplinary Committee shall provide the respondent with a "reasonable time" to file an answer to the charge(s). In Investigation 11-I-09, the sole trade practice disciplinary matter during the target period, respondents were given 10 days to file a written answer to charges and request a hearing.

the respondent pursuant to Exchange rules.<sup>102</sup> Alternatively, the respondent is permitted to submit an offer of settlement. The Disciplinary Committee has the authority to accept or decline a settlement offer but may delegate such authority to A&I. If a settlement cannot be reached and the respondent requests a hearing, an Exchange hearing committee (“Hearing Committee”) will convene as soon as practicable.

For contested matters, the Hearing Committee has the authority to conduct full evidentiary hearings to determine whether rule violations did in fact occur. The Hearing Committee consists of five members, including the Chairperson of the Board (“Chairperson”) who selects three Exchange members, and a person who qualifies as a “public director.”<sup>103</sup> No person is permitted to serve as a member of the Hearing Committee if the person, or firm with which the person is affiliated, has a financial, personal or prejudicial interest or concern in the matter before the committee.<sup>104</sup> Also, persons who have participated in or been involved in adjudicating any other stage of the same proceeding are prohibited from serving on the Hearing Committee.<sup>105</sup> In advance of a hearing, the respondent has the right to examine all relevant documents or other tangible evidence in the possession of the Exchange.<sup>106</sup> The respondent is entitled to representation of his or her choosing before the Hearing Committee and may offer evidence in his or her defense.<sup>107</sup> The Hearing Committee has the authority to require the

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<sup>102</sup> MGEX Rule 603.00.

<sup>103</sup> MGEX Rule 265.00.

<sup>104</sup> MGEX Rule 265.01.

<sup>105</sup> *Id.*

<sup>106</sup> MGEX Rule 609.00.

<sup>107</sup> MGEX Rules 605.00 and 609.00.

presence of witnesses and the submission of pertinent books and records.<sup>108</sup> No formal rules of evidence apply. A&I is responsible for presenting its case before the Hearing Committee.

Following a hearing, the Hearing Committee will issue a written decision setting forth its findings and, where it concludes that violations were committed, imposing sanctions.<sup>109</sup> The decisions of the Hearing Committee constitute the final decisions of the Exchange and are not subject to appeal within the Exchange.<sup>110</sup>

### **B. Adequacy of Sanctions Imposed**

During the target period, A&I referred one substantive trade practice investigation (Investigation 11-I-09) to the FTCC.<sup>111</sup> As discussed below, Division staff reviewed Investigation 11-I-09 and found that the fines imposed by the FTCC in this case generally appear reasonable relative to the violations alleged and the evidence presented.<sup>112</sup>

In Investigation 11-I-09, A&I recommended that the FTCC authorize a Notice of Charges be issued to two brokers, employed by the same clearing firm, for engaging in a series of prearranged, non-competitive wash trades in HRSW futures contracts.<sup>113</sup> With respect to the clearing firm, A&I recommended that the FTCC issue a Notice of Charges to the firm to ensure

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<sup>108</sup> MGEX Rules 605.00 and 610.00.

<sup>109</sup> MGEX Rule 615.00.

<sup>110</sup> MGEX Rules 265.03, 605.00, and 615.00.

<sup>111</sup> A&I did not issue any staff warning letters for trade practice violations during the target period. However, after the target period, in Investigation 11-I-14, A&I issued a warning letter for sharing Tag 50 IDs. *See supra* Section VII.D.2.

<sup>112</sup> *See supra* Section VIII.A where the Division further explains that disciplinary matters during the target period were reviewed by either the FTCC or BCC. In October 2012, the Exchange amended its disciplinary rules and replaced the FTCC and BCC with the Disciplinary Committee. The Division also notes that the Hearing Committee did not review any matters during the target period.

<sup>113</sup> A&I also determined that one of the brokers traded against his own orders in apparent violation of MGEX Rule 1806.00.

that the firm would be held accountable for the actions of its two employees and for failing to reduce a customer order to writing, or other form of permanent record upon receipt, when the order was not immediately executable.<sup>114</sup> In its investigation report prepared for Investigation 11-I-09, A&I also stated that a review of the respondents' disciplinary histories revealed no prior violations of similar rules. The FTCC, after reviewing the investigation report, considering the respondents' disciplinary histories, and listening to A&I's presentation of the case, authorized A&I to issue a Notice of Charges to the two brokers and the clearing firm. In addition, the FTCC authorized A&I to reach a settlement in satisfaction of the Notice of Charges. Without admitting or denying the violations, the three respondents each submitted an Offer of Settlement: one broker agreed to pay a \$10,000 fine; the second broker agreed to pay a \$5,000 fine; and the clearing firm agreed to pay a \$25,000 fine. Consistent with the FTCC's authorization, A&I accepted the settlement terms for all three respondents in satisfaction of the charges. The Division believes that the fines in this case were of sufficient magnitude for all three respondents.

### **C. Timeliness of Disciplinary Proceedings**

Division staff determined that Investigation 11-I-09 was resolved in a timely manner once the investigation was submitted to the FTCC. Approximately 53 days elapsed between the completion of the investigation and the execution of the settlement agreements.

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

The Division found that MGEX has a generally adequate disciplinary program that includes appropriate disciplinary procedures. The Exchange has the authority to investigate possible rule violations, prosecute cases, and discipline members who are found guilty.

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<sup>114</sup> MGEX Rule 1807.00.



Respondents receive adequate notice of the claims against them, and have sufficient opportunity to request a hearing, present their defenses, and offer evidence. Respondents also are afforded the right to counsel and may enter into settlement negotiations.

During the target period, one investigation involving substantive trade practice violations was referred to the FTCC. The case resulted in settlements with each respondent and fines totaling \$40,000. The Division found that the fines imposed were generally reasonable relative to the violations alleged and the evidence presented. The Division also found that the investigation was resolved in a timely manner.

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

## **IX. DISPUTE RESOLUTION PROGRAM**

### **Pre-Amendment of the CEA by the Dodd-Frank Act**

#### **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.**

### **Post-Amendment of the CEA by the Dodd-Frank Act**

#### **Core Principle 14 – 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.**

During the entirety of the target period, the acceptable practices set forth in Appendix B to Part 38 of the Commission's regulations provided that an exchange is required to provide customer dispute resolution mechanisms that are fair, equitable, and available on a voluntary

basis.<sup>115</sup> Customers should have the opportunity to have their claims heard and decided by an objective and impartial decision maker. In addition, each party should have the right to counsel, adequate notice of claims presented against him or her, and an opportunity to be heard on all claims, defenses, and counterclaims. The process should provide for a prompt hearing, as well as prompt, written final settlement awards that are not subject to appeal within the exchange. The parties should also be notified of the fees and costs that may be assessed. Finally, if an exchange provides procedures for the resolution of member-to-member disputes (not involving customers), the procedures for resolving such disputes must be independent of, and not interfere with, the resolution of customer's claims or grievances.

#### **A. MGEX Arbitration Procedures**

MGEX provides dispute resolution services for resolving disputes between Exchange members and their customers through its Customer Claims Arbitration program. Customers of Exchange members can submit any dispute arising out of a trade made on the Exchange for arbitration by filing a written complaint with the Exchange within two years after the date of the transactions from which the dispute arose.<sup>116</sup> If a customer files an arbitration complaint, the member involved must file an answer to the complaint or risk having the complaint decided based on available evidence and testimony.<sup>117</sup>

Complaints are arbitrated by a Customer Claims Arbitration Panel ("Panel") typically consisting of three Exchange members whose principal business activity is related to futures and

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<sup>115</sup> See discussion of applicable guidance and acceptable practices *supra* note 4.

<sup>116</sup> MGEX Rule 510.01.

<sup>117</sup> MGEX Rule 513.00.

options trading.<sup>118</sup> Members are appointed to serve on the Panel by the Exchange's President or Secretary.<sup>119</sup> All proceedings are governed by the standards of the American Arbitration Association.<sup>120</sup>

Written complaints, answers, and replies are served on both parties.<sup>121</sup> Each side must cooperate in voluntary exchange of relevant documents and information, and the Exchange must make available any relevant documents in its possession.<sup>122</sup>

Complaints are heard in a hearing before the Panel, at which each party has the right to be represented by counsel and to present statements and question witnesses under oath.<sup>123</sup> The Panel must issue a decision in writing as soon as practicable after the hearing.<sup>124</sup> Decisions must be based on the record of the hearing, and are final and binding on the parties.<sup>125</sup> No appeal is permitted except where required under applicable law.<sup>126</sup>

There were no arbitrations at MGEX during the target period.<sup>127</sup>

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<sup>118</sup> MGEX Rule 502.00. Pursuant to MGEX Rule 503.00, the complainant has a right to demand that the panel be comprised of a majority of persons who are not Exchange members and not associated with any members.

<sup>119</sup> MGEX Rule 502.00.

<sup>120</sup> MGEX Rule 501.01.

<sup>121</sup> MGEX Rules 511.00 and 512.00.

<sup>122</sup> MGEX Rule 517.00.

<sup>123</sup> MGEX Rules 524.00 and 523.00.

<sup>124</sup> MGEX Rule 530.00.

<sup>125</sup> MGEX Rules 530.00 and 532.00.

<sup>126</sup> MGEX Rule 532.00.

<sup>127</sup> During the target period, the Exchange did receive a written complaint related to a cash market transaction. The Exchange served the complaint on the respondent and the parties settled the matter outside of arbitration.

## **B. Conclusions and Recommendations**

The Division found that MGEX's rules provide fair and equitable procedures for the resolution of customer disputes. Each party has the right to counsel and each party receives adequate notice of the claims presented against them and an opportunity to be heard on all claims. MGEX's arbitration procedures require a prompt hearing and authorize prompt, written, final settlement awards that are not subject to appeal within the Exchange. Since there were no arbitrations during the target period, the Division was unable to evaluate the adequacy of the Exchange's dispute resolution program.