MARKET SURVEILLANCE
RULE ENFORCEMENT REVIEW
OF THE
CHICAGO MERCANTILE EXCHANGE

COMMODITY FUTURES TRADING COMMISSION
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Division of Market Oversight
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I. INTRODUCTION

The Division of Market Oversight ("Division") has completed a rule enforcement review of the market surveillance program of the Chicago Mercantile Exchange ("CME" or "Exchange") for compliance with applicable provisions of Section 5(d) of the Commodity Exchange Act ("Act"), as amended by the Commodity Futures Modernization Act of 2000 ("CFMA"), and Part 38 of the Commission's regulations. The review covers the target period of September 1, 2001 to September 1, 2002.[1]

The review focuses on two core principles that relate to an exchange's market surveillance program. Core Principle 4, *Monitoring of Trading*, relates to an exchange's program to prevent manipulation, price distortion, and disruptions of the delivery or cash settlement process. Core Principle 5, *Position Limitations or Accountability*, relates to an exchange's program for enforcing its speculative position limits and position accountability rules. Appendix B to Part 38 provides acceptable practices for demonstrating compliance with Core Principles 4 and 5.

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

For purposes of this review, Division staff interviewed officials and market surveillance staff from the Exchange's Division of Market Regulation ("Market Regulation").[2] The Division also reviewed numerous documents used by Exchange staff in carrying out the Exchange's market surveillance responsibilities. These documents included, among other things, the following:

- computer reports generated by the Exchange's automated surveillance systems and other documents used in market surveillance and speculative limit and position accountability enforcement;
- files and records concerning contract expirations, speculative limit and position accountability enforcement, and speculative limit exemptions;
- market surveillance files for investigations closed during the target period;[3] and
- the Exchange's market surveillance procedures manual and guidelines.

The Division provided the Exchange an opportunity to review and comment on a draft of this report on July 7, 2003. On July 15, 2003, Division staff conducted an exit conference with Exchange officials to discuss the report's findings and recommendations.

[2] A copy of the October 10, 2002 transcript of those interviews can be found in Appendix 1.

[3] Because no market surveillance matters were referred for disciplinary action during the target period, there were no disciplinary files for Division staff to review.

II. SUMMARY OF FINDINGS AND RECOMMENDATIONS

A. Surveillance of Market Activity

Findings

- On a daily basis, market surveillance staff review cash and futures prices, spread differentials, volume, open interest, large trader and clearing member positions, supply and demand fundamentals, and market news. This information is used in connection with routine surveillance of market activity and contract expirations.
- Market surveillance staff review several large trader reports daily to monitor large positions. Large trader data are included in the Exchange's Regulatory Position System, which permits users to access data through a series of computer reports and on-line screen applications that analyze large trader activity according to pre-determined sorts. Users also have the flexibility to sort and analyze data based on individually selected criteria.
- Surveillance of expiring contracts is tailored to individual markets and the sector in which they trade. For physically-delivered agricultural contracts, CME focuses on monitoring open interest, deliverable supply, and the ability of shorts to make delivery, in addition to cash and futures prices and large trader information. To ensure that futures and cash prices converge as delivery approaches, analysts regularly contact hedgers, producers, and users in agricultural markets to keep apprised of underlying cash markets.
- As expiration approaches for the Exchange's cash-settled financial contracts, CME primarily focuses on the potential for price manipulation, rather than on deliverable supply and participants' ability to deliver, as it does for agricultural contracts. In doing so, market surveillance staff focuses on price movement and the identity and positions of large traders in the market.

The Division has no recommendation in this area.

B. Enforcement of Speculative Position Limits and Position Accountability Rules

Findings

- The Exchange has adequate procedures for reviewing hedge exemption applications and for monitoring for possible speculative limit violations and traders who exceed position accountability thresholds.
- Staff reviews large trader reports daily to detect positions in excess of the Exchange's speculative position limits and to examine large trader activity for indications of accounts that should be aggregated for speculative limit purposes.
- Speculative position limit investigations were thorough, well documented, and closed in a timely manner. On average, investigations were open for only 35 days.
- Position accountability inquiries were thorough and contained adequate documentation. However, the Division found that four of 14 position accountability inquiries were open for lengthy periods of time, ranging from approximately 90 to 236 days. The delays in closing three of the investigations appear attributable to firms or individuals failing to timely respond to an Exchange request for information. There was no evidence in the respective investigation files that the Exchange made follow-up telephone calls or sent reminder letters in an effort to collect the requested information.

Recommendation

The Exchange should improve the timeliness of its position accountability inquiries by promptly following-up on information requests with telephone calls and letters, and if a response is not immediately forthcoming, take appropriate action.

C. Enforcement of Exchange EFP Rules

Findings

- During the target period, 7,524,614 contracts, representing two percent of the Exchange's volume, were executed via 306,758 EFP transactions. Currency EFPs accounted for approximately 85 percent of the Exchange's EFP volume and 98 percent of EFP transactions.
- The Exchange experienced significant growth in EFP volume in interest rate and equity index products. Specifically, 549,578 interest rate contracts and 554,279 equity index contracts were transacted via EFP, accounting for approximately 15 percent of the Exchange's EFP volume. Agricultural EFPs accounted for less than one-half of one percent of the Exchange's EFPs.

- The Exchange reviews a daily report to identify EFPs that may have unusual characteristics that warrant further investigation to ensure that the EFPs are bona fide and comply with EFP rules.
- This methodology resulted in the initiation of 16 EFP investigations during the target period. Four of the investigations involved currency EFPs, and six each involved agricultural and equity index EFPs. No interest rate EFP investigations were opened during the target period. Given that currency EFPs represent such a large percentage of EFP volume and transactions, and in view of the significant growth in the use of interest rate EFPs, the Exchange should examine a larger number of EFPs in these products to ensure that member firms are complying with Exchange rules.
- The Exchange completed 17 EFP investigations during the target period. The investigations were thorough, adequately documented, and completed in a timely manner.

Recommendation

The Exchange should review its EFP program and implement modifications to ensure that an adequate number of currency and interest rate EFPs are examined for compliance with Exchange rules.

D. Adequacy of Miscellaneous Market Surveillance Investigations

Findings

- Exclusive of speculative limit, position accountability, and EFP investigations, the Exchange closed eight additional market surveillance investigations during the target period.
- With the exception of a revocation of a hedge exemption, all of the miscellaneous investigations were closed with no further action.
- The investigations were completed expeditiously, well documented, and conducted in a thorough manner.

The Division has no recommendation in this area.

III. SURVEILLANCE OF MARKET ACTIVITY

A. Market Surveillance Staffing

Market Regulation administers the Exchange's market surveillance and trade practice surveillance programs. Market Regulation's market surveillance staff includes an Associate Director, three managers and five analysts.[4] These nine individuals have considerable industry and Exchange experience ranging from three years to more than 25 years.[5]

The market surveillance management team includes three product managers who report to the Associate Director of Market Surveillance. The three product managers include the Associate Director of Financial Surveillance, the Manager of Agricultural Surveillance, and the Manager of Currency Markets. The financial surveillance product manager directly supervises one "senior analyst," one "experienced analyst," and one analyst who monitor all financial contracts (*i.e.*, interest rate and equity products). The agricultural surveillance product manager directly supervises two "experienced" analysts who monitor all agricultural products. The currency surveillance product manager monitors all currency products. The Associate Director of Market Surveillance oversees all market surveillance operations and reports directly to the Managing Director of Regulatory Affairs.

Market surveillance staff reviews large trader and clearing member positions, EFPs, transfer trades, prices, volume, open interest, and other market factors on a daily basis. Each

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[4] The Surveillance Systems Manager and two database specialists also assist market surveillance staff.

[5] The Associate Director of Market Surveillance, who was a member of the Exchange's International Monetary Market ("IMM") for 21 years, has served in his current position for five years. Prior to this position, he was a compliance consultant for the Exchange for two years. While an IMM member, he worked as a floor trader/broker for six years and served as a floor manager for a futures commission merchant ("FCM") for 13 years. The financial surveillance product manager has a total of 18 years of Exchange experience, including 14 years in market surveillance. The agricultural surveillance product manager has a total of 15 years of Exchange experience, including 9½ years in market surveillance. The currency surveillance product manager has a total of 20 years of industry experience, including seven years in Exchange market surveillance. The five market surveillance analysts have Exchange market surveillance experience ranging from three years to 17 years.

analyst, as well as the currency surveillance product manager, is responsible for monitoring trading activity and market developments in each of their assigned contracts.[6] Analysts also contact major market participants to gain first-hand knowledge regarding their particular markets.

The Exchange's Market Surveillance Guidelines ("Guidelines") are used for training and reference purposes. The Guidelines outline general market surveillance procedures and include, among other things, an overview of market surveillance activities, contract specifications, and sections regarding data collection, data analysis, speculative position limits, position accountability, and EFP reviews. The Guidelines also include a list of all computer-generated reports available to market surveillance staff on a routine basis and position limit exemption applications. Market surveillance managers and analysts also attend Exchange-hosted seminars to further augment their industry knowledge. In addition, staff may attend committee meetings associated with particular Exchange products to gain further insight and knowledge.

The Division found that the Exchange's market surveillance staff is sufficiently experienced and knowledgeable to conduct the Exchange's market surveillance program.

B. Prices, Volume, Open Interest, and Market News

On a daily basis, market surveillance staff collects and analyzes price, volume, open interest, and market news in all Exchange-traded contracts. This information is used in connection with routine surveillance of market activity and contract expirations. As explained below, use of on-line quotation systems combined with computer-generated reports enhance staff's ability to conduct several types of analyses quickly and efficiently.

[6] Staff has access to Globex observation terminals to observe real-time Globex trading.

Price data and market information are collected from a variety of sources, including Bloomberg, Reuters, the Internet, and "Mercquote," the Exchange's real-time, in-house quotation system. Mercquote is directly tied into the price quotation boards on the Exchange's trading floor.[7] The system allows staff to identify and monitor unusual price changes and abnormal price relationships on a real-time basis. Mercquote also displays intra- and inter-commodity spread quotations and prices from external sources, such as the Chicago Board of Trade and the U.S. Department of Agriculture ("USDA").

In addition, market surveillance staff makes extensive use of the Daily Information Bulletins produced by CME's Statistics Department. These bulletins, which reflect various market data for the previous day's trading session, provide a ready source of futures price data, as well as information relating to the underlying cash markets.[8] The bulletins also contain volume and open interest statistics and the daily high, low, and settlement prices for each futures and options contract. Staff also has on-line access to a historical statistical database that includes two years of open interest and volume data. The database allows staff to construct historical comparisons to analyze the relative liquidity of each market.

For a detailed analysis of open interest, staff reviews the Commitment Report. This report lists open interest by contract and contract month. Within each contract month, the report is divided into customer, house, and combined house and customer positions for each clearing member. Each of these three positions is then divided into gross long and gross short positions, with the net change of positions from the previous business day also shown.[9] The report is

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[7] CME price, volume, and open interest information also is disseminated on the Exchange's website and to venders who publish electronically.

[8] Cash market information includes livestock and meat prices from the USDA, U.S. Treasury Bill auction results, and foreign exchange currency data. A copy of a Daily Information Bulletin can be found in Appendix 2.

[9] A copy of the Commitment Report can be found in Appendix 3.

primarily used to identify potential concentrations of positions at one or more clearing firms. The report also is used to monitor the level of open interest in a contract as it approaches last trading day to help determine whether the contract is liquidating in an orderly manner.

C. Large Trader Position Reporting

CME Rule 8.17 requires clearing members to report daily all positions for all entities, which, at the close of trading, own any position greater than or equal to the reportable position levels (gross long or short) established by the Exchange for each contract.[10] To ensure compliance with CME Rule 8.17, the Exchange compares large trader reportable data to open interest data. If a large percentage of unreported positions are identified for a particular firm, the firm is contacted and asked to identify those positions that were not reported. Typically, the firm's back office system has either incorrectly identified or omitted a reportable account. Large trader position data are used to enforce compliance with CME regulations regarding reportable accounts, speculative position limits, open interest reporting, aggregation of accounts, and for risk management purposes.

Subsequent to the Division's previous rule enforcement review of the CME, dated September 28, 1999 ("1999 Review"), the Exchange upgraded its large trader reporting system. Large trader data are now included in the Exchange's Regulatory Position System ("RPS"). RPS, which contains two years of position data, has more functionality and provides users with greater flexibility than the older system.[11] For example, RPS has account search tools and allows users to merge different data streams. In addition, all reports used to review large trader activity are available on-line. Users can access data through a series of computer reports and on-line

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[10] A list of all CME reportable levels can be found in Appendix 4.

[11] The Exchange's previous large trader reporting system only maintained six months of position data on-line. Data older than two years are archived. Presently, the Exchange has 20-years of archived position data. RPS also includes position, clearing, and account data.

screen applications that analyze large trader activity according to predetermined sorts. RPS also provides users with the capability to sort and analyze data based on individually selected criteria.

Market surveillance staff analyzes several RPS reports daily to monitor large trader activity. Among these reports are several versions of the Watch/Account Report.[12] A watch/account is a set of accounts that are grouped together based on specific criteria, such as common ownership or control, or that exhibit similar trading patterns.[13] The Watch/Account Reports allow the Exchange to determine at any given point the total market exposure of market participants in a particular watch/account and to detect potential concentrations of positions as they develop. RPS also has enhanced staff's capability to sort watch/account data. For example, an analyst may choose a watch/account with or without option positions, ranked by net futures equivalents, or ranked by overall combined positions. In addition, position data for all accounts with the same watch number can be extracted to review the trading activity for a particular large trader.

The Book Report is another RPS large trader report routinely used by staff to monitor large traders. The Book Report is sorted by commodity and contract month, as well as by clearing firm, account number, account title, and position.[14] The report indicates each reportable account's current position, the previous day's position, and the change between the two, and provides staff with a useful tool for monitoring position limit violations and concentrations of positions among related accounts. The Book Report also is reviewed daily for occurrences of unusually large position changes and unusual trading activity.

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[12] Copies of the Watch/Account Reports can be found in Appendix 5.

[13] Each account number contained within RPS may be assigned up to six multiple "watch numbers" and more than one account can be assigned the same watch number.

[14] A copy of the Book Report can be found in Appendix 6.

D. Contract Expirations

1. Overview

Market surveillance staff monitors maturing contracts on a daily basis to detect and prevent market disruptions, avoid delivery defaults, and ensure orderly liquidations. As expiration approaches, staff focuses on any anomalies in trading patterns and market activity as compared with prior expirations. Staff also closely monitors cash and futures prices, spread and basis relationships, size and ownership of deliverable supply for physical delivery contracts, clearing member positions, large trader positions relative to the total open interest, and the positions of large traders.

In addition, staff monitors position adjustments and transfer trades using the Position Adjustment Report and the Transfer Report.[15] The Position Adjustment Report indicates an adjustment to a firm's open interest made necessary when a clearing member incorrectly reports its position. The Transfer Report allows analysts to monitor position transfers from one account to another, either within the same firm or from one firm to another. This report is used to monitor the movement of large positions from one firm to another, and to identify any positions transferred that may have resulted in a change in ownership in violation of the Exchange's open outcry requirements.

2. Surveillance Tailored to Different Markets

Expiration surveillance is tailored to individual commodities and the sectors in which they trade. For instance, the Exchange's expiration surveillance for agricultural products significantly differs from that conducted for financial products due to the difference in the availability of cash market information and the method of delivery. Information concerning the

[15] Copies of the Position Adjustment Report and the Transfer Report can be found in Appendix 7.

underlying cash markets for financial products is readily available through news services, the Internet, and other sources. However, the same is not true for agricultural products. Three or four days can pass in the live cattle and hog cash markets without a reported cash quote. Therefore, to ensure that futures and cash prices converge as delivery approaches, analysts regularly contact hedgers, producers, and users in the agricultural markets to keep apprised of underlying cash markets.

Agricultural contract expirations present additional concerns because most agricultural contracts, unlike the Exchange's financial contracts, are settled via physical delivery.[16] The physical delivery aspect requires that the Exchange closely monitor available supply and participants' delivery intentions to ensure orderly liquidations. In this connection, the CME Clearinghouse produces several reports that allow the Exchange to monitor the deliverable supply of products stored in Exchange-approved warehouses, *e.g.*, frozen pork bellies and butter. These reports list certified loads by location and clearing member firm. For currencies and non-storable deliverable products such as live cattle and lumber, Exchange and Clearinghouse staff contact clearing member firms during the delivery period regarding each short position holder's ability to make delivery.

The Exchange monitors deliveries by reviewing the Blotter Report. The report, which is compiled by the Clearinghouse, is a chronology of long positions sorted by firm and trade date. The report is constructed only for expiring contracts and is used by the Clearinghouse for the assignment of deliveries.[17] Analysts use the Blotter Report to determine which firms and traders

[16] Milk, Class IV Milk, Non-Fat Dry Milk, Feeder Cattle, and Lean Hogs are the Exchange's only cash-settled agricultural contracts. Although the Exchange's currency contracts are physically-delivered, for surveillance purposes they are treated more like cash-settled financial contracts due to their virtually unlimited supply.

[17] Deliveries are assigned on the basis of the first delivery going to the holder of the oldest open position. A copy of the Blotter Report can be found in Appendix 8.

may be in position to receive deliveries, a significant factor in those commodities where deliverable supply may be limited. The Blotter Report also is used to identify situations where a trader might use the delivery process, or the taking of deliveries, to influence futures prices during a contract's expiration.

As expiration approaches for the Exchange's cash-settled and currency contracts, analysts primarily focus on the potential for price manipulation, rather than on deliverable supply and participants' ability to deliver, as it does for agricultural contracts. In doing so, market surveillance staff focuses on who the market participants are and how their trading activity compares to their trading activity during prior expirations. For example, an analyst may take notice and question a market participant who is not rolling a position into the next deferred month as it usually does, or pay close attention to a market participant with a long position going into expiration if that same participant typically maintained a short position during past expirations or vice versa.[18]

Surveillance for the S&P 500 and Eurodollar contracts, both of which are cash-settled, is tailored to the individual characteristics of those markets. The S&P 500 contract is unique in that the last day of trading for the expiring contract is the Thursday prior to "triple witching Friday."[19] Positions in the S&P 500 futures contract are marked to market at the close on Thursday and then the contract is settled on Friday morning based on the first trade in each underlying component of the S&P 500 equity index. The Exchange has developed a special report for monitoring the expiration of the S&P 500 futures contract, the "Index Arbitrage

[18] Analysts also look for atypical trading activity in agricultural contracts. For example, in July 2002, trading in the expiring July 2002 Lumber futures contract appeared typical based on past experience. However, market surveillance staff noticed that the profile for the September 2002 contract at the time was changing earlier than would be expected. Surveillance was intensified for the September contract, although the July contract was still trading, and CME staff was in frequent contact with Commission staff until the September 2002 contract expired.

[19] Triple witching Friday is the third Friday of March, June, September, and December when stock index futures are settled and stock index options and stock options contracts expire on the same day.

Participants Report." The report is a spreadsheet created for each trading day during the last two weeks of trading that contains gross long and short positions, day-to-day positions and position changes, and chronicles position concentrations relative to open interest.[20] The report apprises the Exchange of participants who may be using the S&P 500 futures contract for index arbitrage purposes in the days leading up to expiration.[21] Keeping track of the potential number of contracts associated with index arbitrage allows the Exchange to predict the level of volatility that can be anticipated on the Friday morning's opening during which the S&P 500 futures contract final settlement price is determined. In addition to assisting with predicting expiration morning volatility, the Index Arbitrage Participants Report serves as a tool to monitor large position holder activity.

The Eurodollar market is unique, because unlike other Exchange contracts, the front month contract is not considered the expiring contract for surveillance purposes. In Eurodollars, open interest and volume typically move forward a few months prior to expiration of the lead contract and the next deferred contract, in effect, becomes the front month. Consequently, market surveillance staff focuses it surveillance activities on the next deferred month at an early stage. Expiration of the spot month, therefore, generally is not significant for surveillance purposes because the bulk of open positions have long been rolled forward into the deferred months and users who are in the market at expiration are balancing an existing cash portfolio against expiring contracts.

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[20] A sample of an Index Arbitrage Participants Report can be found in Appendix 9.

[21] Index arbitrage is a trading strategy that seeks to exploit the spread differential (the basis) between the futures and the underlying equity basket at expiration. The strategy dictates that traders purchase (sell) a basket of equities while simultaneously selling (buying) an equivalent dollar value of futures contracts. At expiration, the stock basket is unwound while the futures positions are allowed to expire to cash settlement. Because the values of both instruments will converge at expiration, depending on transaction costs and "cost of carry," a profit opportunity can exist if the original pricing was favorable.

3. Expiration Summary Files

Division staff examined 13 expiration summary files ("ESFs") prepared by the Exchange during the target period. These included six agricultural ESFs, six financial ESFs, and one currency ESF that contained 11 separate currency expirations.[22] ESFs for physically-delivered agricultural contracts contained data that primarily focused on delivery, including closing summary memoranda that provided details regarding the certified deliverable loads reported at the beginning and end of the delivery period, the number of deliveries that took place during the delivery period, and the number of contracts open on the last trading day. In addition, delivery and open interest statistics were compared to the same expiration in the previous year. These ESFs also contained logs documenting staff's conversations with market participants and Commission staff, cash and futures price data, large trader position information, and pertinent news stories.

Documentation in ESFs for cash-settled financial contracts and physically-delivered currencies, on the other hand, demonstrated the Exchange's focus on monitoring price movement and large trader positions in those contracts. For example, the November 2001 Eurodollar ESF included several different reports generated by the Exchange's large trader reporting system, including the Book Report and various Watch/Account reports.[23] The ESF also contained six-month price charts with volume and open interest statistics and Bloomberg tables listing the British Bankers' Association ("BBA") survey of member banks' Libor rates and U.S. dollar interest settlement rates. CME uses BBA interest settlement rate data to compile a document that

[22] The 13 ESF's examined were prepared for the following contracts: November 2001 and June 2002 Eurodollars, March 2002 S&P 500, June 2002 Euroyen, September 2001 NASDAQ-100, November 2001 Lumber, December 2001 and August 2002 Live Cattle, August 2002 Lean Hogs, September Nikkei 225, February and March 2002 Frozen Pork Bellies, and March 2002 Currencies (including British Pound, Australian Dollar, Canadian Dollar, E-mini Eurodollar F/X, Japanese Yen, E-mini Japanese Yen, Mexican Peso, South African Rand, Eurodollar F/X British Pound, and Eurodollar F/X Japanese Yen).

[23] The contents of the Book Report and Watch/Account reports are discussed at p. 10.

shows CME Eurodollar positions held by BBA member banks at expiration and their survey settlement quotes. The final cash-settled price for expiring Eurodollar contracts is based on the survey of BBA interest settlement rates. The document allows the Exchange to see whether a bank's settlement quote may have been influenced by its Eurodollar position. Similarly, for each currency, the March 2002 Currency ESF also included several reports generated from the Exchange's large trader reporting system, including the Account Positions by Contract Month Report and Book Report. The ESF also included for each currency a summary sheet listing up to the ten largest long and short position holders, an Open Commitment by Position Account Report that showed total open interest by firm and account number and name, and several graphs relating to technical price data.

IV. ENFORCEMENT OF SPECULATIVE POSITION LIMITS AND POSITION ACCOUNTABILITY RULES

A. Speculative Positions Limit Exemptions

Market Surveillance staff also are responsible for reviewing and processing speculative position limit exemption applications. Pursuant to CME Rule 543, speculative limit exemptions may be granted for bona fide hedges, risk management positions,[24] arbitrage/inter-commodity spread positions, option-option and option-future spreads, and independently controlled positions.[25] A separate exemption application must be completed for each commodity or approved inter-commodity spread for which an exemption is sought.

[24] CME Rule 543A.2. defines "risk management positions" to include futures and options in financial or index markets (1) which are held on behalf of a commercial entity or an affiliate of a commercial entity that typically buys, sells or holds positions in the underlying or a related cash market, (2) for which the underlying cash market has a high degree of demonstrated liquidity relative to the size of positions, and (3) which satisfy one or more of three specified sets of criteria.

[25] Entities eligible for independently controlled position exemptions include commodity pool operators and commodity trading advisors which authorize an independent account controller to control all trading decisions for positions they hold directly or indirectly, but without day-to-day direction. The aggregate position held or controlled by each such account controller may not exceed the speculative position limits. CME Rule 543.G.

In general, each exemption application requests the hedger or spreader to specify, in futures equivalents, the maximum number of contracts, long and short, sought for each future month and for all months combined.[26] The Exchange grants each exemption in futures-equivalent form, allowing any combination of futures and options in the hedging or spreading strategy, as long as the total futures-equivalent position does not exceed the granted exemption level.

No trader is allowed to exceed a speculative position limit in an agricultural commodity until he or she has filed the appropriate application and received Exchange approval. Unlike agricultural exemptions, traders in financial markets, except stock indexes, are permitted to exceed the limits for several days prior to filing an application--five business days for new applicants and ten business days for traders who want to increase an existing exemption.[27] A trader intending to exceed speculative position limits in stock index futures may request verbal approval prior to exceeding such limits. If the request is granted, an application must be filed promptly thereafter.

Agricultural hedge exemptions are granted on a calendar-year basis and traders must reapply in the fall of each year, while financial hedge exemptions must be renewed bi-annually. During the target period, the Exchange granted exemptions to 58 entities in at least one type of agricultural commodity, and to 21 entities in at least one financial contract. Although no hedge exemption applications were denied during the target period, some exemption requests were granted at levels lower than requested.

[26] Since the 1999 Review, the Exchange has modified its hedge exemption application for agricultural contracts. The modified applications, which allow applicants to complete the form in a detailed step-by-step manner, have significantly streamlined the application and approval process. A copy of a modified hedge exemption application can be found in Appendix 10.

[27] All IMM and Index and Option Market contracts except lumber, gasoline, crude oil, and options on cattle and hogs, are considered to be financial contracts.

Division staff reviewed hedge exemption files for 14 entities, which included multiple exemptions of differing types in different contracts. The Division found that the Exchange completed its review of exemption applications in a timely manner and that the files contained adequate supporting documentation. Each file included appropriate applications, formal approval forms and letters. In addition, agricultural exemption files included spreadsheet analyses addressing spot month, scale down, non-spot, and all-months-combined exemption requests.

B. Speculative Limit Violations

Market surveillance staff reviews large trader reports, including the Position Limit Report, daily to detect positions in excess of the Exchange's speculative position limits and to examine large trader activity for indications of accounts that should be aggregated for speculative limit purposes.[28] The Position Limit Report lists accounts that are near or over speculative position limits. If an account or group of aggregated accounts is over the limit, an investigation is opened and the clearing firm(s) carrying the account(s) is immediately contacted via telephone. The clearing firm is instructed to reduce the position or have the account owner apply for an exemption, if eligible, and a warning letter or cease and desist order is issued.[29]

During the target period, 13 speculative position limit violation investigations were closed, nine of which involved agricultural markets and four of which involved financial markets. The Division reviewed all 13 of the investigations and found that they were thorough, well documented, and closed in a timely manner. On average, each investigation was open for only 35 days. Warning letters were issued in connection with all of the investigations and a

[28] A copy of the Position Limit Report can be found in Appendix 11.

[29] A staff warning letter is issued to first time speculative limit violators. Another violation within 12 months of the warning letter will result in a cease and desist order and a possible fine. CME Rule 443.A.

cease and desist order was issued as a result of one of the investigations.[30] In each instance investigated, the position was promptly reduced or an exemption application was submitted in a timely manner.

C. Position Accountability

Eurodollars, currencies, currency cross-rates, one-month LIBOR, and two- and five-year swap contracts are subject to the Exchange's position accountability rules. In place of absolute position limits, the accountability rules mandate levels, or thresholds, at which large traders may be required to respond to special requests by the Exchange for information relating to their positions. Specifically, the accountability rules provide that any trader who exceeds the former speculative position limits, which were replaced by accountability levels, will be required to "provide, in a timely fashion, upon request by the Exchange, information regarding the nature of the position, trading strategy, and hedging information if applicable."[31]

The Exchange initiates a position accountability inquiry when positions for any account or group of aggregated accounts exceed previous speculative limit thresholds. In response to a recommendation made in the 1999 Review, the Exchange has expanded its Market Surveillance Guidelines to include procedures for conducting position accountability inquiries. Under the procedures, an investigation file is opened for each inquiry and a standard letter is sent to the account owner or controller, directing that the following information be submitted within 21 days:[32] (1) the name, address, and telephone numbers of all account owners; (2) the nature of

[30] The Exchange issued a warning letter in connection with a Live Cattle speculative limit violation. Shortly thereafter, the Exchange realized that it was a second violation in a 12-month period and issued a cease and desist order. Investigation No. 01-19568-MS.

[31] The Exchange's position accountability rules are found within the respective chapter governing the particular contract market.

[32] If the account owner or controller is not an Exchange member, the Exchange will contact the clearing firm carrying the position and the clearing firm will forward the letter to the account owner or controller. Typically, responses are sent directly to the Exchange.

business of all account owners; (3) the name and title of each person responsible for trading control; (4) a description of how the futures and/or options positions in the particular contract are utilized;[33] and (5) a list of all clearing members or non-clearing FCMs or foreign brokers where accounts are maintained, including account numbers and the account executives. Subsequent to an initial inquiry, any account or group of accounts that remains over the position accountability threshold is contacted bi-annually to ascertain whether material issues affecting the account(s) have changed.[34]

The Division reviewed the files for the 14 position accountability inquiries closed by the Exchange during the target period. The inquiries were thorough and contained adequate documentation. Each file included a General Investigation Form that contained relevant information regarding the matter, including a brief description and the final disposition; a Position Limit Report; and a copy of the information request letter and responses. However, the Division identified several inquiries that were open for lengthy periods of time before requested information was submitted and a determination was made. In one inquiry that remained open for 131 days, the Exchange requested account information on January 22, 2002, but did not receive a response until May 27, 2002. In another inquiry that remained open for 106 days, the Exchange requested account information on December 6, 2001, but did not receive a response until March 21, 2002.[35] Another position accountability inquiry remained open for 236 days, but the

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[33] With respect to how the futures and/or options positions are utilized, the Exchange requests information regarding (1) the percentage of the long side and/or the short side that is a hedge, arbitrage, spread, or speculative position; (2) the characterization of the underlying instruments hedged or arbitraged; (3) the dollar value of each underlying position; and (4) the calculation used to determine the number of futures and/or options positions related to each type of underlying position.

[34] The position accountability threshold for Eurodollars is 10,000 contracts. However, because large positions are common in Eurodollars, once an initial position accountability inquiry is conducted for an account, a follow-up inquiry is opened only if an account's position exceeds 50,000 contracts. For all other contracts subject to position accountability rules, the threshold for initial contact and follow-up inquiries is the same.

[35] Investigation Nos. 02-19983-MS and 01-19837-MS, respectively.

Division was unable to discern the reason for the delay from the documents in the file.[36] Finally, one inquiry remained open for over 90 days after a firm submitted an unsigned and incomplete CFTC Form 102 rather than responding to the questions in the standard letter.[37]

There was no evidence in the files examined by the Division to indicate that the Exchange made follow-up telephone calls or sent reminder letters in an effort to collect requested information. Although the Exchange's standard information request letter states that CME Rule 432.1 deems failure to submit requested information within 30 days a "major" offense, no actions were brought during the target period for violation of this rule in connection with a position accountability inquiry. The Division believes that to ensure prompt receipt of requested material, when necessary, the Exchange should follow-up with telephone calls and letters, and if a response is not immediately forthcoming, take appropriate action under CME Rule 432.1. In this manner, position accountability inquiries can be completed in a more timely fashion.

V. ENFORCEMENT OF EXCHANGE EFP RULES

A. Applicable Rules

The Exchange has two rules authorizing EFP transactions: CME Rule 538--Transfer of Spot for Futures, and CME Rule 719--Transfer of Cash for Futures after Termination of Contract.[38] CME Rule 538 permits EFPs during the course of trading of the futures contract,

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[36] When questioned by the Division, Exchange staff explained that a firm's proprietary account exceeded the applicable position accountability threshold on a Wednesday and that an inquiry was immediately opened and the firm contacted. The firm notified the Exchange that it would take longer than usual to provide the information because the firm had just merged with another firm. By the following Monday, the account had dropped below the threshold. The Exchange never received the requested information but the matter was kept open to monitor the account. Although the firm advised the Exchange that there would be a delay in submitting the requested material, the Division nevertheless believes that the Exchange should have followed-up and closed the inquiry in a more expeditious manner.

[37] CFTC Form 102 is intended to identify account owners and to provide account control and contact information when an account first becomes reportable, not to address speculative limit or position accountability issues. Although the Exchange conducted no further probing, the inquiry remained open for more than three months after the firm submitted the incomplete form. Investigation No. 01-18413-MS.

[38] The Exchange prohibits EFPs in E-mini and options contracts.

while CME Rule 719 authorizes EFP transactions after expiration of a contract.[39] All EFPs must be recorded on a trading card or order ticket by both parties to the transaction and, following execution, be both confirmed to the customer and submitted to an Exchange employee at the relevant quadrant's pulpit for posting on the trading floor. CME Rule 538 requires that clearing members and brokers maintain full documentation of each EFP transaction. Parties to an EFP executed pursuant to CME Rule 719 must also file with the Clearinghouse all documentation necessary to verify the nature of the transaction.[40] On November 5, 2000, the Exchange issued an EFP questions and answers document ("Q&A") to provide members with a better understanding of EFP requirements. The Q&A clarifies the Exchange's EFP rules and addresses questions regarding reporting, clearing, and documentation requirements.[41]

During the target period, 7,524,614 contracts, representing two percent of the Exchange's volume, were executed via 306,758 EFP transactions.[42] Currency EFPs totaled 6,419,354 contracts, or approximately 85 percent of the Exchange's EFP volume.[43] In addition, since the 1999 Review, the Exchange has experienced significant growth in EFP volume in interest rate and equity index products. During the target period, these markets together accounted for approximately 15 percent of the Exchange's EFP volume as opposed to five percent in 1999.

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[39] Under CME Rule 538, an exchange of actual ("spot") commodities for futures contracts requires: (1) a buyer of the spot (seller of the future) or a seller of the spot (buyer of the future) to have the commodity in his or her possession; (2) the purchase and sale of the futures contract simultaneous to the sale and purchase of an equal quantity of the spot; (3) a mutually agreed upon price; and (4) the reporting of the transaction to the Exchange's Department of Regulation. EFPs executed pursuant to CME Rule 719, in addition to the above requirements, are subject to the approval of the Exchange President; however, this approval has been delegated to the Exchange clearinghouse.

[40] EFP documentation is defined in Commission Regulation 1.35 (a-2) (4) as "those documents customarily generated in accordance with cash market practices which demonstrate the existence and nature of the underlying cash transactions, including, but not limited to, contracts, confirmation statements, telex printouts, invoices, and warehouse receipts or other documents of title."

[41] A copy of the Exchange's EFP Q&A can be found in Appendix 12.

[42] These transactions included 300,431 currency EFPs, which accounted for nearly 98 percent of the Exchange's total EFP transactions, 2,044 interest rate EFPs, 4,179 equity index EFPs, and 104 agricultural EFPs.

[43] EFPs also accounted for approximately 29 percent of total currency volume.

Specifically, 549,578 interest rate contracts and 554,279 equity index contracts (most in the S&P 500 futures contract) were transacted via EFP.[44] Only 1,403 agricultural contracts were traded via EFPs during the target period, accounting for less than one-half of one percent of the Exchange's EFP volume.

B. Surveillance Procedures

Market surveillance staff use the "Cash-For-Futures Monthly Summary Report" and the "House-to-House Cash for Futures Report" to monitor EFP transactions. The Cash-For-Futures Monthly Summary Report shows EFP volume relative to total volume by commodity sector. Each month, staff can determine what percentage of total volume was in the form of EFPs in any particular contract or across all contracts, identify the firm that clears the most EFPs in any month in any particular contract or in all contracts combined, and compare EFP volume by sector to the previous two months or prior year.[45]

The "House-to-House Cash for Futures Report" is a daily report that shows EFPs cleared by the Clearinghouse. Among other things, for each cleared EFP the report lists the commodity, clearing firm, customer account number, CTI code, quantity bought or sold, trade price, opposite clearing firm, trade date and execution time, and submission date and time.[46] The Exchange uses the report to identify EFPs that may have unusual characteristics, such that they warrant further investigation. Unusual characteristics might include an EFP between two locals, an EFP that

[44] The growth was most dramatic in interest rate contracts. During the 1999 Review target period, only 987 interest rate contracts were executed through EFPs. Although not as dramatic, EFP volume in equity index contracts also significantly increased. During the 1999 Review target period, 328,641 equity index contracts were executed through EFPs.

[45] A copy of the Cash-For-Futures Monthly Summary Report can be found in Appendix 13.

[46] A copy of the House-to-House Cash for Futures Report can be found in Appendix 14.

takes longer than usual to clear, an EFP executed at a price significantly different from the market price, or an EFP transacted by an account with which staff is unfamiliar.[47]

Once a transaction is selected for review, an analyst sends a request to the clearing firm(s) involved seeking documents relative to the underlying cash activity associated with the EFP. The submitted documentation is then examined to ensure that the cash instrument is acceptable and that the quantity of the cash instrument is roughly equivalent to the number of futures contracts submitted. The Exchange closed 17 EFP investigations during the target period, including six that were opened prior to the target period. Division staff examined those 17 EFP investigations and found that they were thorough, adequately documented, and completed in a timely manner.

During the target period, the Exchange reviewed 16 EFPs for compliance with Exchange rules. These included four currency EFP investigations, six agricultural EFP investigations, and six equity index EFP investigations. Given that currency EFPs represent 85 percent of EFP volume and 98 percent of EFP transactions, and in view of the significant growth in interest rate EFPs, the Division believes that the Exchange should examine a larger number of EFPs in these products to ensure that member firms are complying with Exchange rules. Increased coverage of these EFPs is essential to ensure that EFPs are bona fide and not designed to accomplish an unlawful purpose. Since it does not appear that staff's routine review of the House-to-House Cash for Futures Report yields a sufficient number of currency or interest rate EFPs with unusual characteristics, the Division believes that the Exchange should review its EFP program and implement modifications to ensure that an adequate number of these EFPs are examined for compliance with Exchange rules.

[47] For instance, during the target period, the Exchange reviewed a Feeder Cattle EFP transaction between two Canadian entities because it was the first time staff had seen an EFP involving these entities. Investigation No. 02-20106-MS

VI. ADEQUACY OF MISCELLANEOUS MARKET SURVEILLANCE INVESTIGATIONS

Exclusive of the previously discussed speculative limit, position accountability, and EFP investigations, the Exchange closed eight additional market surveillance investigations during the target period. Division staff reviewed all eight of these investigations for adequacy and timeliness. Five of the investigations were initiated from customer complaints. Three of the complaints involved prices in CME's spot call butter market (with two of the complaints coming from the same individual), one complaint involved prices in CME's spot cheese market and milk futures contract, and one complaint involved prices in CME's live cattle market. In addition, one investigation was opened in response to news reports of a market participant's involvement in an alleged Ponzi scheme involving cash cattle. CME examined the participant's futures trading activity, and although the Exchange found no violation of CME rules, the participant's hedge exemption was revoked. The final two investigations involved an aggregation analysis of particular accounts in Live Cattle and a review of trading on the Exchange prior to the September 11, 2001 terrorist attacks. With the exception of the hedge application revocation, all of investigations were closed with no further action.

The Division found that the investigations were completed expeditiously, were well documented, and were conducted in a thorough manner. For example, the Exchange analyzed three months of activity in the spot butter market to determine whether there was a clear pattern of manipulative price activity on the close, as the complaint alleged. The Exchange identified all trading sessions that closed with a last trade price that was higher than the previous trade price, and analyzed the buy-side activity. The Exchange found that during the 17 sessions identified, the buying activity was dispersed among eight of 14 total buy-side participants. The Exchange also found that there were only two instances in which the same buyer transacted a higher priced last trade with the same seller. A similar analysis over the same time period was conducted to identify all trading sessions that closed with a last trade price that was higher than the average of all prices for that session. The Exchange found that this occurred 20 times and that the buying activity was spread among nine of the 14 participants. Again, only twice did the same buyer transact a higher priced last trade with the same seller. Based on its analysis of three months of activity, the Exchange concluded that there was no clear evidence to support any allegation of collusion or to establish a pattern of price manipulation on behalf of any particular participants.

VII. CONCLUSIONS AND RECOMMENDATIONS

The Division found that the Exchange maintains an adequate market surveillance program that includes routine monitoring of futures and cash prices, spread relationships, volume, open interest, deliverable supply, clearing member positions and market news. Market surveillance staff also analyzes several large trader reports daily to monitor large trader activity and to identify unusual activity that could impact orderly liquidations. Large trader data are included in the Exchange's Regulatory Position System that provides staff with the capability to analyze large trader activity on-line according to predetermined sorts or to analyze data based on individually selected criteria.

The Exchange tailors surveillance of expiring contracts to the characteristic of individual markets and the sector in which they trade. In this connection, expiring contract surveillance of agricultural contracts primarily focuses on deliverable supply, the ability of shorts to deliver, and open interest relative to deliverable supply, while surveillance of cash-settled financial contracts primarily focuses on the monitoring of price movement and large trader positions.

The Division also found that the Exchange has adequate procedures to review hedge exemption applications and to monitor for possible speculative limit violations and for traders who exceed position accountability thresholds. In addition, the Exchange's market surveillance related investigations were thorough, well documented, and completed in a timely manner. However, the Division found that the Exchange did not open a sufficient number of currency and interest rate EFP investigations during the target period to ensure that clearing members executing EFPs in these products are complying with Exchange EFP rules and procedures. Sixteen EFP investigations were opened during the target period, including four currency EFP investigations, six agricultural EFP investigations, and six equity index EFP investigations. No interest rate EFP investigations were opened. Given that 85 percent of the Exchange's EFP volume and 98 percent of its EFP transactions were in currencies, and that the Exchange has experienced significant growth in the use of interest rate EFPs, the Division believes that a larger number of these EFPs must be examined to verify compliance with Exchange rules.

Finally, the Division found that four of the 14 position accountability inquiries were open for lengthy periods, ranging from approximately 90 to 236 days. The delay in closing three of the inquiries was attributable to firms or individuals failing to timely respond to a routine Exchange request for information concerning the size and nature of the positions. There was no evidence in the respective files that the Exchange made follow-up telephone calls or sent reminder letters in an effort to collect the requested information.

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

- **Review its EFP program and implement modifications to ensure that an adequate number of currency and interest rate EFPs are examined for compliance with Exchange rules.**
- **Improve the timeliness of position accountability inquiries by following-up on information requests with telephone calls and letters, and if a response is not immediately forthcoming, take appropriate action.**