

**MARKET SURVEILLANCE  
RULE ENFORCEMENT REVIEW  
OF THE  
NEW YORK MERCANTILE EXCHANGE**



**Division of Market Oversight  
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# MARKET SURVEILLANCE RULE ENFORCEMENT REVIEW OF THE NEW YORK MERCANTILE EXCHANGE

## I. INTRODUCTION

The Division of Market Oversight (“Division”) has completed a rule enforcement review of the market surveillance program of the New York Mercantile Exchange (“Exchange”), including its Commodity Exchange, Inc. division, 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.<sup>1</sup> The review covers the target period of September 1, 2001 to September 1, 2002.<sup>2</sup>

The review focuses on two core principles that relate to an Exchange’s market surveillance program: Core Principle 4, *Monitoring of Trading*, which relates to an exchange’s program to prevent manipulation, price distortion, and disruptions of the delivery or cash settlement process, and Core Principle 5, *Position Limitations or Accountability*, which relates to an exchange’s program for enforcing its speculative position limits and position accountability

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<sup>1</sup> The Exchange is comprised of two divisions, the NYMEX division and the COMEX division, which were formed by the merger of the New York Mercantile Exchange and the Commodity Exchange, Inc. in 1994. After the merger, the trading operations of each exchange were continued as the two divisions, offering trading in their respective futures and options contracts: energy, platinum, and palladium for the NYMEX division, and gold, silver, and copper (plus aluminum, added since the merger) on the COMEX division. Because some Exchange computer systems and data sources used for market surveillance cover only one or the other of the divisions, for purposes of clarity this review will refer to the “Exchange” when referencing the entire New York Mercantile Exchange, to “NYMEX” when referencing only the NYMEX division, and to “COMEX” when referencing only the COMEX division.

<sup>2</sup> Rule enforcement reviews prepared by the Division are intended to present an analysis of an exchange’s overall compliance capabilities for the period under review. Such reviews deal only with programs directly addressed in the review and do not assess all programs. The Division’s analyses, conclusions, and recommendations are based, in large part, upon the Division’s evaluation of a sample of investigation and disciplinary case files, and other exchange documents. This evaluation process, 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.

rules. Appendix B to Part 38 provides acceptable practices for demonstrating compliance with Core Principles 4 and 5.

For purposes of this review, Division staff interviewed officials and staff from the Exchange's Market Surveillance Department ("MSD").<sup>3</sup> The Division also reviewed numerous documents used by MSD in carrying out the Exchange's routine 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, position accountability enforcement, and speculative position limit exemptions;
- market surveillance inquiry, investigation and disciplinary action files for cases closed or conducted during the target period;
- the Exchange's Market Surveillance Procedures Manual and guidelines; and
- minutes of all Control Committee meetings and all other meetings of committees responsible for market surveillance matters during the target period.

The Division provided the Exchange an opportunity to review and comment on a draft of this report on May 27, 2003. On June 3, 2003, Division staff conducted an exit conference with Exchange officials to discuss the report's findings and recommendations.

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<sup>3</sup> A copy of the October 30, 2002 transcript of those interviews can be found in Appendix 1.

## II. SUMMARY OF FINDINGS AND RECOMMENDATIONS

### A. Findings

- The Exchange maintains an adequate market surveillance program. MSD is sufficiently staffed and experienced to carry out the Exchange's daily surveillance of market activity.
- MSD conducts daily monitoring of futures and cash market prices, market news, volume, open interest, deliverable supply, clearing member and large trader positions, and data on available supply and demand relating to each Exchange contract. MSD heightens surveillance of expiring contracts either one or two months prior to expiration, in order to facilitate orderly liquidations.
- Relevant data and exception reports are available to and sortable by MSD analysts through automated computer systems, including the Exchange's Large Trader Reporting System. These systems give MSD access to the positions and trading of market participants and provide an automated means of detecting any violations of position limits or speculative limit exemptions.
- The Exchange also has an adequate program for investigating possible market surveillance-related rule violations. During the target period, MSD conducted a total of 422 inquiries and 18 investigations. Inquiry and investigation files were well documented and appropriate investigative analyses were performed. The Exchange also imposed sanctions appropriate to the wrongdoing found. In the single investigation which uncovered violations defined as major offenses, the Exchange accepted a settlement including a fine of \$100,000 and a cease and desist order for violations of its speculative position limit rules. MSD also issued a total of 40 warning letters and 15 advisory letters during the target period.
- MSD maintains a computer database of exchange of futures for physicals and exchange of futures for swap transactions, and analysts review the details of EFPs and EFSs several times each week. Two hundred fifteen of the 422 target period inquiries conducted by MSD involved EFPs, and 84 involved EFSs. Of the 215 EFP inquiries, 208 concerned EFPs involving NYMEX contracts, while seven concerned EFPs involving COMEX contracts. The disproportionate scrutiny applied to NYMEX EFPs during the target period could indicate that some COMEX EFPs which deserve closer examination may not be receiving it.
- A significant number of EFP and EFS inquiries were open for long periods of time, some for more than one year. Allowing large numbers of inquiries to remain open for long periods may create a backlog of EFP and EFS inquiries which could impede effective Exchange review of such transactions and diminish deterrence.

## **B. Recommendations**

- **The Exchange should review its EFP inquiry program and implement modifications necessary to ensure that an adequate number of COMEX EFPs are scrutinized, and improve the timeliness of EFP and EFS inquiries.**

## **III. SURVEILLANCE OF MARKET ACTIVITY**

### **A. Market Surveillance Department**

The Exchange's market surveillance program is conducted by MSD, which is part of the Exchange's Compliance Department. MSD consists of a Director, an Associate Director, three Supervisors, four analysts, and three clerical staff persons.

During the target period, the Exchange restructured MSD. The Associate Director position and one Supervisor position were added, and three Manager positions were eliminated through attrition. Under the new structure, one Supervisor is responsible for the analysts' surveillance of the Exchange's markets; one is responsible for review of large trader reports and clearing member reporting; and one handles processing of large trader reporting system data and EFP transaction data. The Associate Director oversees all of these areas and is responsible for approval of all hedge exemptions. As part of the restructuring process, MSD also created guidelines for daily market surveillance activities and analysis, and revised and updated its Market Surveillance Procedures Manual.<sup>4</sup>

Each analyst is assigned primary market surveillance responsibility for eight to ten Exchange contracts. In addition, a second analyst is assigned backup responsibility for each contract, while all analysts are responsible for additional backup as needed. This insures continuous coverage of each contract, and also increases cross-training so that all analysts are familiar with all Exchange markets.

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<sup>4</sup> A copy of the Market Surveillance Procedures Manual can be found in Appendix 2.

As discussed in detail below, MSD staff conduct daily monitoring of futures and cash prices, market news, volume, open interest, deliverable supply, and data on available supply and demand relating to each contract. The procedures analysts follow are detailed in the Exchange's Market Surveillance Procedures Manual. Each analyst's daily routine for surveillance of his or her assigned contracts includes comprehensive review of market data, clearing member and large trader positions, the previous trading day's price performance, industry statistics on cash and futures prices and supply/demand fundamentals, and general market research. Analysts also review exchange of futures for physicals and exchange of futures for swaps transactions. Data concerning trades executed on the Exchange's ACCESS electronic trading system is available to MSD analysts in the same manner as open outcry data, and analysts follow the same procedures for reviewing both.

The Division found that MSD is sufficiently staffed and experienced to carry out the Exchange's daily market surveillance program.

#### **B. Prices, Volume, and Open Interest**

Each analyst is responsible for monitoring market developments, changes in both futures and cash prices, and spread relationships in each of his or her assigned markets. The principal electronic tool MSD staff use for these purposes is the Bloomberg News Service, which provides real-time news and cash market prices, and the ability to chart historical price relationships for various markets. Staff can also consult the Exchange's computerized record of historical Exchange prices, called the price data sheet. Research concerning market news is conducted on the Nexis computer database. Analysts also review trade publications, such as Platt's Metals Weekly and Petroleum Intelligence Weekly, as well as major financial news publications, including The Wall Street Journal, New York Times, and Financial Times for price information and news. In addition to consulting computer and print data sources, MSD also conducts

frequent telephone interviews with both cash and futures market participants and with industry analysts in order to compare price data, analyze the supply and demand components of the market, and identify unusual or abnormal price relationships.

MSD analysts also review the previous trading day's volume and open interest for their assigned contracts on a daily basis. Volume data for NYMEX contracts is available to analysts online, and can be sorted by contract and trade type as desired. COMEX daily volume data is available in hard-copy form. Analysts obtain open interest data from the Daily Open Interest Reports generated by the Exchange for both NYMEX and COMEX commodities and for both futures and options. These reports display both open interest for a given trade date and the change up or down from the previous trade date.<sup>5</sup> In addition, exception reports generated by the Exchange's Large Trader Reporting System, including the Futures Open Interest Exception Report and the Options Open Interest Exception Report, enable the analyst to determine what percentage of open interest a reportable trader's position represents.<sup>6</sup> In situations where historical data is needed, analysts can obtain complete Exchange price, volume, and open interest data for any date from 1986 to the present, in sortable Excel spreadsheet form, from the Exchange's Statistics Department.

For NYMEX contracts, three additional data sources concerning volume and open interest are available. Analysts can access intra-day volume data for NYMEX contracts through the NYMEX Trade Matching System ("TMS"). They can also view a current "snap shot" of the positions of any NYMEX clearing member via open interest reports available from the Exchange's clearing system. In addition, analysts can consult the Exchange's daily "Futures

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<sup>5</sup> Copies of Daily Open Interest Reports from the target period can be found in Appendix 3.

<sup>6</sup> Copies of a Futures Open Interest Exception Report and Options Open Interest Exception Report from the target period can be found in Appendix 4.



CFTC Report,” which lists each clearing member’s long and short positions and total open interest in each NYMEX futures contract for the previous trading day.<sup>7</sup>

### **C. Deliverable Supply**

MSD monitors deliverable supply for metals contracts through the daily reports of warehouse stocks which the Exchange requires from each approved metals warehouse. Each daily report lists the amount in the warehouse on the previous day, any amounts received or withdrawn, the net change, and the resulting total stock for the day in question. Analysts examine these reports for indications of sudden or trending shifts in the availability of deliverable supply and the ownership of deliverable stocks. On a daily basis, MSD staff review the reports and retain the information in spreadsheet form.<sup>8</sup>

MSD monitors deliverable supply for energy products, in part, through data obtained from the Department of Energy, the Energy Information Administration, and the American Petroleum Institute. MSD staff also contact clearing members and large customers directly with deliverable supply inquiries relating both to upcoming contract expirations and to general market conditions. Similar inquiries are made to cash brokers and large commercial customers such as major oil companies. MSD staff then compare the information thus obtained with the data available through Bloomberg and other research services.

As discussed below, MSD increases its attention to deliverable supply information and its relationship to open interest and other relevant data during monitoring of expiring contracts.

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<sup>7</sup> A copy of a Futures CFTC Report from the target period can be found in Appendix 5.

<sup>8</sup> The information obtained is also made public through the Exchange’s Corporate Communications Department, which posts it on the Exchange’s web site and disseminates it to various news services. A copy of an MSD spreadsheet containing metals warehouse stock data can be found in Appendix 6.

#### **D. Contract Expirations**

MSD heightens surveillance of expiring contracts in order to facilitate orderly liquidations. The heightened surveillance typically begins one, or in some cases, two months before the delivery month and is intensified during the entire delivery month. MSD staff focus on closely monitoring relationships between cash and futures prices, spread and basis relationships, size and ownership of deliverable supply, clearing member positions, and size and ownership of large trader positions relative to total open interest and deliverable supply. Analysts also conduct frequent telephone interviews with cash and futures market participants whenever market conditions warrant. The decision on whom and when to call is made by the analyst involved in consultation with a supervisor. Analysts may inquire as to the economic reason for the participant's present position and the participant's plan for liquidating it. Short position holders are typically asked to certify verbally that they are able to make delivery. During the expiration monitoring process, analysts also maintain a dialogue with Commission surveillance staff as appropriate.

After contract expiration, MSD monitors the delivery process. MSD maintains similar contacts with market participants to ensure that delivery instructions are submitted in a timely manner and that deliveries proceed according to Exchange rules and procedures. In this process, MSD works with the Exchange Delivery Committee, which meets after expiration of a contract if any potential delivery problems arise.

MSD takes a particularly aggressive approach to monitoring contract expirations in platinum and palladium, because their supply is limited and a lack of warehouse stocks can lead to expiration problems. Throughout the two months prior to expiration, MSD staff maintains a dialogue with clearing members to remind them of their customers' obligations respecting orderly liquidations and inquire concerning customers' intentions. If a customer does not intend

to make delivery or lacks the capability to do so, MSD requires that the customer liquidate its position in an orderly manner or roll the position forward. MSD monitors the liquidation or roll.

MSD also takes an aggressive approach to monitoring potential congestion problems that could affect delivery in connection with contract expirations in the two New York Harbor contracts, heating oil and gasoline. Delivery on both of those contracts occurs out of the same terminals within various five-day windows. During the expiration month, the Exchange requires all short position holders to notify the Exchange of which terminal(s) they plan to use for delivery. MSD records this data in an Excel spreadsheet in order to compare it with the physical capacity of the terminals, and contacts position holders immediately to resolve potential physical congestion problems.

Price charts, volume and open interest data, warehouse stock reports, news articles, notes of conversations with customers and clearing members, and other data reviewed by analysts with regard to the expiring contract are maintained in a “control file” for each expiration. The Division reviewed 15 representative control files across Exchange markets, and found that each contained appropriate data, correspondence and information.

Information gathered in control files is shared with members of the Exchange’s Control Committee when MSD determines that a potential expiration problem exists. The Control Committee is responsible for correcting any circumstances which could interfere with the normal functioning of the market.<sup>9</sup> A Control Committee Subcommittee of three members is appointed

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<sup>9</sup> Under NYMEX Rule 3.17, circumstances which might interfere with the normal function of the market include: “events, conditions or positions which threaten or might threaten a free, open and orderly market, the fair and orderly trading in any commodity futures or options contracts, the orderly liquidation of any commodity futures or options contract or delivery pursuant to any futures contract; a distortion of prices; a congestion, squeeze or corner or circumstances or positions which might result therein; positions of any person or group of persons which might lead to any of the foregoing results or which are out of proportion to his or their ability to perform their contracts; or any events, and, circumstances or positions which threaten or might threaten the best interests of the Exchange or the public.”

for each contract traded on the Exchange. MSD convenes a meeting of the relevant subcommittee whenever necessary to address potential contract expiration or other market problems. Such meetings are attended by the analyst responsible for the contract as well as by MSD supervisory personnel. The Subcommittee reviews information concerning the largest long and short position holders and their delivery intentions, as well as data on open interest, volume, price, spread differentials, deliverable supply, cash market data, comparable historical data, and any other information potentially affecting the market. The Subcommittee has the authority to assemble information on open positions at any time, and can require any member or member firm to provide requested information or allow examination of its books and records.<sup>10</sup>

During the target period, MSD found it necessary to convene only two Control Subcommittee meetings. Both involved palladium futures expirations. The palladium Subcommittee met in late January 2002 to discuss the March 2002 expiration because there was a high level of open interest and low levels of depository stocks. The Subcommittee contacted the largest short customers well before first notice day concerning their intentions and ability to deliver, and MSD closely monitored deliverable supply, market composition, and price. The Subcommittee met again in August 2002 to discuss the September 2002 expiration, which was subject to a spike in the futures price due to short covering, along with similarly low warehouse stocks. The Subcommittee chairman and MSD staff maintained close observation of the market until a significant decline in open interest reduced the potential problem. In the end, both contracts liquidated in an orderly fashion, without market disruption.

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<sup>10</sup> See NYMEX Rule 3.17(E).

## **E. Large Trader Reporting System**

Exchange rules require clearing members, omnibus accounts and foreign brokers to provide close-of-business position data for all reportable traders to MSD in computerized form by 8:00 a.m. each day.<sup>11</sup> MSD maintains this data in a computer data bank known as the Large Trader Reporting System (“LTRS”), which contains data from December 1999 to the present. The data received each morning is entered into the system and available to analysts by 9:00 a.m. the same day it is received. LTRS also receives the details of each cleared trade through a feed from the Exchange’s clearing system.

In addition, the Exchange requires clearing members, omnibus accounts and foreign brokers to identify each account which exceeds reportable levels, by filing a CFTC Form 102 (“Identification of Special Accounts”) for that account with MSD within one business day of the first time the account becomes reportable.<sup>12</sup> The Exchange also requires a clearing member, omnibus account or foreign broker who has filed Form 102 to update the form within one business day of any material change in the information it contains. The information on the form, which identifies reportable futures and options traders and provides information on account ownership and control, is also entered into LTRS.

MSD assigns a unique LTRS identification number to each trader who becomes reportable. LTRS uses this identification number to aggregate the trader’s positions at multiple

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<sup>11</sup> See NYMEX Rule 9.33 and COMEX Rule 4.46(c). Rule 9.33 requires omnibus accounts and foreign brokers to submit a signed reporting agreement to MSD, confirming that the omnibus account or foreign broker will report daily to the Exchange all customers that own or control positions which equal or exceed Exchange customer reporting levels. Rule 4.46(c) does not specify a similar requirement, but in practice the Exchange obtains similar agreements regarding COMEX trading. An omnibus account or foreign broker who fails to submit a signed agreement or to report positions as required by Exchange rules is subject to a hearing by the Business Conduct Committee to limit, condition or deny access to the market.

<sup>12</sup> Form 102 is designed to comply with the provisions of Commission Regulation 17.01(b). Although COMEX Rule 4.46(c) does not explicitly require omnibus accounts and foreign brokers to file Form 102, in practice the Exchange obtains these forms from such accounts and brokers with respect to COMEX trading as well as NYMEX trading.

clearing members. MSD also assigns a group identification number to entities that are apparently affiliated, and LTRS uses this number to aggregate the positions of all related affiliates.

LTRS generates various reports which MSD uses to monitor reportable traders and violations of reporting requirements, speculative position limits, and hedge exemption limits. The reports include the Customer Position Ranking Report, which gives position ranking by customer; the Futures Open Interest Exception Report and Options Open Interest Exception Report, which identify the percentage of open interest held by each customer with positions exceeding the report's parameters; the Spot Month Customer Net Position Limit Report and the Any/All Month Net Position Limit Exemptions Report, which identify customers who have exceeded position limits, hedge exemption limits or all-month accountability levels; the Unmentioned Exception Report, which shows any difference between an omnibus account's reported positions and those actually held for it by its clearing member; and the Unreported Exception Report, which shows any difference between a clearing member's open interest and reportable positions.<sup>13</sup> LTRS reports concerning aggregated affiliates identify both the aggregate entity and the individual entities making up the aggregate.

Each analyst conducts daily review of the various LTRS reports concerning the contracts for which he or she is responsible. To enhance detection of potential position reporting problems, shortly after the end of the target period, MSD instituted a program under which the supervisor responsible for LTRS meets weekly with each MSD analyst to review all large trader exception reports for that analyst's assigned contracts. The meetings are held to ensure that each analyst is properly interpreting LTRS data and taking appropriate action when warranted. MSD

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<sup>13</sup> Copies of these reports from the target period can be found in Appendix 7.

estimates that during the target period, review of large trader reports generated as much as 90 percent of the market surveillance inquiries opened by MSD.<sup>14</sup>

## **F. Position Limits, Position Accountability, and Hedge or Swap Exemptions**

### **1. Position Limits and Position Accountability**

Exchange rules bar market participants from holding or controlling net futures equivalent positions in the spot month which exceed specified position limits.<sup>15</sup> Exchange rules also require any market participant whose net futures equivalent position exceeds position accountability levels set by the Exchange to provide to the Exchange upon request information concerning, among other things, the size and nature (e.g., speculative, hedge, or involving a swap or spread) of the position and the trading strategy involved.<sup>16</sup> Under these rules, a market participant holding a position exclusively in a spot month is subject to a speculative position limit; a market participant who holds a position solely in the back months is subject to a position accountability level; and a participant holding positions in both the spot and back months is subject to both a speculative position limit and a position accountability level. To determine the size of an all-months-combined position, the Exchange nets long and short futures positions, and converts option positions to their futures equivalents.

To monitor for potential position limit violations and instances where position accountability is triggered, the MSD analyst assigned to each contract conducts daily review of a number of LTRS customer warning reports and ranking reports for that contract. Customer warning reports reviewed include the Spot Month Customer Net Position Limit Report, which lists customers and groups whose spot-month futures positions exceed the speculative position

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<sup>14</sup> Inquiries and investigations are discussed below at pages 26-29.

<sup>15</sup> See NYMEX Rule 9.27(B) and (C) and COMEX Rule 4.47(b).

<sup>16</sup> See NYMEX Rule 9.26 (“All Month/Any One Month Position Accountability”) and COMEX Rules 4.47(b) and 4.48 (“Position Accountability”).

limit or their respective hedge exemption limits; the Any/All Month Net Position Limit Exemption Report, which lists customers and groups whose any-month or combined all-months futures-equivalent positions exceed speculative position limits, hedge exemption limits, or all-months accountability levels; the Customer Gross Position Limit-Options report, which lists, by calls and puts, all customers and groups whose all-months gross options positions exceed accountability levels; the Spot-Customer Net Futures Equivalents report, which lists, by option contract, all customers and groups whose current delivery month net futures-equivalent positions exceed speculative position limits or hedge limits; and the Futures Open Interest Exception Report and Options Open Interest Exception Report, which lists customers and groups whose positions exceed a predetermined percentage of open interest for any month or for all months combined.

Ranking reports reviewed include the Futures Customer Position Ranking-By Contract report, the All Months Customer Position Ranking Report, the Customer Options Position Ranking-By Underlying Contract report, and the All-Month Customer Options Position Ranking report, which list gross long and gross short positions for all reportable customers and groups for each contract month and for all months aggregated, and rank accounts in descending order by their net positions. These reports enable the analyst to identify customers or groups with a large percentage of open interest, concentration of open interest by several customers or groups, or accounts that are approaching speculative position or hedge limits. For futures contracts with corresponding option contracts, analysts also obtain ranking information from the Customer Futures Equivalents Ranking Spot Month and All Months reports, which list all reportable traders and groups in descending order by their futures-equivalent positions.<sup>17</sup>

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<sup>17</sup> Copies of the various customer warning and ranking reports from the target period can be found in Appendix 8.



Whenever any of these reports reveal that a market participant has exceeded applicable position limits or accountability levels, the analyst enters the matter into the Rule Violation Log as an inquiry.<sup>18</sup> The analyst first verifies the market participant's position information through direct contact with the participant's clearing member and review of various additional LTRS reports. The analyst also reviews the nature of the customer's business, as well as the customer's percentage of open interest and position ranking in relation to other market participants. If the analyst determines, in consultation with a supervisor, that additional information is needed for adequate analysis of the situation, MSD contacts the market participant (either directly or through the clearing firm involved) for further information regarding the nature and size of the position and the participant's trading strategy, hedging requirements, and financial wherewithal. If at any point in the process the market participant fails to supply any requested information, the Exchange can bar further position increases in or order reduction or liquidation of the position involved.<sup>19</sup>

After conducting this review, the analyst recommends action to be taken by MSD, which may involve instructing the participant to liquidate or freeze its position in whole or in part; requesting that the participant file for a hedge exemption, if appropriate; scheduling a follow-up review; or approving a new position limit or accountability level. In the case of positions that exceed accountability levels, the primary consideration for MSD in deciding whether action is needed is whether trading in the market in question is being improperly or adversely affected by

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<sup>18</sup> As discussed below at pages 26-29, MSD tracks its investigative activity in the form of both inquiries and investigations. Inquiries, which are less formal than investigations, are opened whenever an MSD analyst encounters an anomaly which needs further attention and examination or concerning which documents need to be requested. Inquiries are recorded in the MSD Rule Violation Log, or if they involve EFPs or EFSs are recorded in the EFP or EFS control sheet. MSD opens a formal investigation whenever it discovers possible violations of a serious nature, whenever an inquiry indicates a possible violation of Exchange rules which needs to be pursued further, or whenever a matter is referred by the Commission. Investigations are recorded in the Investigation Register. Copies of the Rule Violation Log and the Investigation Register can be found in Appendix 9.

<sup>19</sup> See NYMEX Rule 9.26(A) and COMEX Rule 4.48.

the size of the participant's position. When MSD determines what action should be taken, the analyst records the results in the comment field of the Rule Violation Log and conveys any needed instructions directly to the market participant.

During the target period, MSD opened 67 inquiries into possible speculative position limit violations, of which nine evolved into investigations. Violations were found in 33 of the 67 inquiries and investigations. Exchange rules provide that a first position limit violation within a twelve-month period will result in issuance of a warning letter, while a second offense within twelve months will receive a summary fine of \$1,000 and a cease and desist order, though the Exchange retains the right to impose additional sanctions where necessary.<sup>20</sup> Warning letters were issued to first-time offenders in eight investigations and 24 inquiries, of which 29 involved NYMEX commodities and three involved COMEX commodities. One investigation which disclosed substantial violations of intra-day hedge exemption limits by a member firm on two consecutive trading days resulted in a \$100,000 fine and a cease and desist order.<sup>21</sup>

MSD also opened 25 position accountability inquiries during the target period. Based upon an analysis of the size and nature of the positions and the trading strategies involved, MSD increased the customers' accountability levels in 16 instances, continued monitoring positions in four instances, and determined in two instances that the applicable accountability level should remain unchanged. In the remaining three instances, customers reduced their positions below the applicable accountability level.

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<sup>20</sup> See NYMEX Rule 9.36. Exact penalties vary slightly with whether the offender is a clearing member, non-clearing member, or customer, depending on the circumstances involved. COMEX does not have a parallel rule regarding summary fines for second offenses, but the Exchange uses Rule 9.36 as a guide in determining sanctions imposed in the event of second offenses at COMEX.

<sup>21</sup> This investigation and the resulting disciplinary action are discussed below at page 27.

The Division reviewed the eight position limit investigation files that resulted in warning letters, and a random selection of 10 of the 24 position limit inquiry files in which warning letters were issued. The Division found that MSD addresses potential violations on a timely basis and that files were well documented. The Division also reviewed the Rule Violation Log comment field entries that concerned the 25 position accountability inquiries. The entries reflected phone contacts made and dispositions reached. In addition, dates recorded on the log indicated that when accountability levels were reached, MSD responded promptly, almost always on the same day, by contacting the customer to obtain the information required under Exchange rules, and that decisions on accountability levels were made in a timely manner. In sum, the Division found that the Exchange has an adequate program for monitoring potential position limit violations and instances where the size of a customer's position initiates a position accountability inquiry.

## **2. Exemptions From Speculative Limits**

Although both hedgers and speculators who hold current delivery month positions are subject to the Exchange's speculative position limits, a customer who qualifies as a bona fide hedge or swap participant with a need for higher position limits can obtain an exemption by filing an exemption application or hedge notice.<sup>22</sup> In addition to filling out the application, the applicant must provide to the Exchange a description of its commercial operations, corporate and

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<sup>22</sup> See NYMEX Rules 9.28 (Exemptions from Position Limits for Bona Fide Hedging Transactions) and 9.29 (Exemptions from Position Limits for Exposure from Commodity Swap Transactions), and COMEX Rule 4.47(h) (Exemptions from Spot Month Speculative Position Limits for Bona Fide Hedging Transactions, Independently Controlled Positions, Spread and Arbitrage Positions, and Commodity Swap Transactions).

subsidiary structure, financial status, risk management programs, and need for the exemption, together with supporting documentation.<sup>23</sup>

The Exchange grants exemptions separately for long and short positions for each commodity. Decisions on whether to grant a requested exemption and on the size of the exemption to be granted are based on a market participant's demonstration of a commercial need for the exemption and of the financial ability to carry such a position through the delivery process, as well as on open interest, deliverable supplies and delivery capacity with respect to the commodity in question. After MSD staff verify the information submitted, applications are reviewed by the Associate Director of Market Surveillance before a final decision as to approval is made by the Senior Vice President of Compliance and Risk Management in consultation with the Associate Director. Most exemptions are effective for one year and roll over into the next expiration for the commodity involved. Once an exemption expires, reapplication is required for exemption renewal. Exchange rules permit the Exchange to revoke, modify, or limit an exemption at any time.<sup>24</sup>

Each month, the Exchange generates a hedge exemption register that lists all entities granted an exemption for each commodity, together with the exemption level and expiration date of each exemption.<sup>25</sup> MSD also maintains a hedge exemption file for each exemption applicant, which contains the application and supporting documentation, MSD work papers, and the Exchange's written grant or denial of the application.

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<sup>23</sup> Exchange rules permit applications to be filed up to five days after a position exceeds the limits with regard to NYMEX contracts other than metals contracts, but require that an application be filed and approved before limits can be exceeded with respect to COMEX contracts. The Exchange President or his designee may authorize the late filing of a hedge notice in special circumstances.

<sup>24</sup> See NYMEX Rule 9.30(A) and COMEX Rule 4.47(k).

<sup>25</sup> A copy of a monthly hedge exemption register from the target period can be found in Appendix 10.

During the target period, MSD took action on 259 exemption applications. MSD approved 26 new applications, and granted 174 applications for renewal or reinstatement of previous exemptions and 18 applications for higher limits, while reducing limits in one case. Twenty-seven exemptions were canceled, revoked, withdrawn, terminated, deleted or expired, and eight applications for a new exemption, a renewal, or an increased limit were denied. Five applications involved the extension of a previously approved exemption.

The Division reviewed seven representative exemption files containing 19 exemption applications, including 11 exemption applications relating to energy contracts involving crude oil, heating oil, unleaded gasoline, and natural gas, and eight applications relating to metals contracts involving gold, silver, copper, aluminum and platinum. Each file was well documented, containing a completed application; annual financial statements; position reports; and other relevant correspondence and memoranda. The files also contained a one-page exemption summary that provides the applicant's contact information, a list of the applicant's previous exemptions and exemption requests, a short description of the applicant's business, financial status and current exemption request, a statement of the Exchange's decision concerning the request, and the expiration date of the exemption if granted.

#### **IV. EXCHANGE OF FUTURES FOR PHYSICALS AND EXCHANGE OF FUTURES FOR SWAPS TRANSACTIONS**

Exchange rules permit the exchange of futures contracts for physical commodities ("EFPs") by means of related and simultaneous cash and futures transactions in which the buyer and seller of the futures are, respectively, the seller and buyer of an approximately equivalent

quantity of the physical commodity.<sup>26</sup> EFP transactions may be effected in all futures contracts offered for trading on the Exchange.

NYMEX rules also permit the exchange of futures contracts for swaps (“EFSs”) by means of related futures and swap transactions in which the buyer and seller of the futures are, respectively, the seller and buyer of a swap involving an approximately equivalent quantity of the commodity underlying the futures contract (or a derivative, by-product or related product of such commodity).<sup>27</sup> The only NYMEX contracts eligible to be included in an EFS are Henry Hub Natural Gas futures and Brent Crude Oil futures. No COMEX contracts are currently eligible for participation in an EFS.

During the target period, 45,214 EFPs involving 2,964,369 contracts were executed at the Exchange. This included 39,748 EFPs involving 2,443,828 NYMEX contracts (2.9% of the total target period volume of 84,174,528 NYMEX contracts), and 5,466 EFPs involving 520,531 COMEX contracts (3.8% of the total target period volume of 13,672,241 COMEX contracts). A total of 2,808 EFSs involving 725,024 NYMEX contracts (0.9% of the total NYMEX target period volume) were executed during the target period.<sup>28</sup>

Exchange rules require that EFP and EFS transactions be posted by the floor members involved immediately upon determination of the terms of the cash or swap transaction, but in no event later than the earlier of the next business day or the end of the permissible posting period

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<sup>26</sup> See NYMEX Rule 6.21 and COMEX Rule 4.36.

<sup>27</sup> See Exchange Rule 6.21A, Exchange of Futures for, or in Connection with, Swap Transactions (Pilot Program).

<sup>28</sup> During the target period, the Exchange began permitting EFP and EFS transactions in OTC contracts designated by the Exchange as eligible for clearing on its ClearPort clearing website. Between May 30, 2002, when the Exchange first offered this service, and the end of the target period, the Exchange cleared 26,364 OTC “Basis Swap” contracts which were involved in 312 EFS transactions.

following expiration of the underlying futures contract.<sup>29</sup> The rules also require clearing members representing the buyer and seller to report each EFP and EFS to MSD by noon of the second business day after the EFP or EFS is posted. The report must include a statement that the EFP has resulted or will result in a change of ownership, or that the swap component of the EFS complied with applicable CFTC swap regulatory requirements and resulted or will result in a change of payments or other such change; the kind and quantity of the futures and the price of the futures transaction; the names of the clearing members and customers involved; and any other information required by the Exchange.

#### **A. Initiation of EFP Inquiries and Investigations**

MSD monitors EFPs and EFSs for compliance with Exchange rules through its database of EFP and EFS transactions (“EFP/S system”), supplemented by LTRS reports and data from NYMEX’s and COMEX’s daily trade registers. The EFP/S system sorts the data by customer, trade date, clearing member, and commodity.<sup>30</sup> Each day, MSD transmits a report to each clearing member listing the previous day’s EFPs and EFSs in which the clearing member was involved. The clearing member must return the report to MSD within two business days after manually entering the identity of the customers involved in each EFP or EFS. MSD staff then enter this information into the EFP/S system.<sup>31</sup>

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<sup>29</sup> NYMEX Rules 6.21 and 6.21A. The immediate posting requirement was imposed during the target period by a rule amendment designed to ensure that trade dates for EFPs and EFSs correspond closely with the date that relevant cash or swap terms are determined. The Exchange amended the rules after MSD investigated three instances where members violated the previous reporting rule during the target period by failing to post EFPs or EFS in the time required.

<sup>30</sup> The data involved includes the identity of executing brokers and clearing members and contract specifications such as quantity, price, and month.

<sup>31</sup> The Exchange is considering switching from obtaining customer data through hand-written reports from clearing members to obtaining it as a string of data from the LTRS in order to reduce the administrative burden on both MSD and the Exchange’s clearing members.

Several times each week, MSD analysts review the details of EFPs and EFSs and the customers involved in each contract for which they are responsible. Analysts open inquiries whenever any anomaly suggests that further examination is warranted. Generally, an EFP or EFS inquiry is opened when the transaction involves an unusually large transaction size, an unusual transaction pattern, a price outside the range for the time period, a relationship between the customers involved, or a customer not previously active in the market in question. In addition, suspicious EFPs and EFSs identified in the course of other investigations are also examined, and some EFP or EFS transactions are selected for inquiry on a random basis.

MSD records EFP and EFS inquiries on an EFP or EFS Control Sheet.<sup>32</sup> An analyst conducting an inquiry obtains relevant documents from the clearing members or customers involved, and reviews them to determine whether the transaction was bona fide and was executed in accordance with Exchange rules.<sup>33</sup> MSD requires that the clearing members provide copies of the cash contracts, each customer's trade blotter, and warehouse receipts or warrants. The Exchange also requests documentation of delivery and payment and copies of all related correspondence between the parties. After consulting with a Supervisor or the Associate Director, the analyst enters a case conclusion comment on the Control Sheet. If rule violations are found or the inquiry evolves into an investigation, the matter is entered in the Rule Violation Log or the Investigation Register.

## **B. Adequacy and Timeliness of EFP and EFS Inquiries and Investigations**

### **1. EFPs**

During the target period, MSD conducted 215 inquiries concerning EFPs, which comprised 51% of the total of 422 inquiries of all types conducted by MSD during the target

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<sup>32</sup> Copies of the EFP and EFS Control Sheets can be found in Appendix 11.

<sup>33</sup> The requirements for bona fide EFPs are set forth in NYMEX Rule 6.21 and COMEX Rule 4.36.



period. Of the 215 inquiries, 208 concerned EFPs involving NYMEX contracts, while seven concerned EFPs involving COMEX contracts. The 208 NYMEX EFP inquiries involved 83,864 contracts, or approximately 3.4% of the total NYMEX EFP volume during the target period. The seven COMEX EFP inquiries involved 5,410 contracts, or approximately 1% of the total COMEX EFP volume during the target period.

MSD closed 138 EFP inquiries during the target period.<sup>34</sup> A total of 66 inquiries were closed without any findings of rule violations, including 64 involving NYMEX contracts and two involving COMEX contracts. An additional 72 inquiries closed during the target period resulted in the issuance of seven warning letters and 14 advisory letters.<sup>35</sup> The seven warning letters and two advisory letters were issued for failure to report an EFP to the Exchange within the time specified by Exchange rules. Twelve advisory letters were issued in connection with a September 2001 amendment to NYMEX's EFP rules, repealed in May 2002, which for approximately nine months barred commercial as well as non-commercial market participants from entering into an EFP during regular trading hours if it was contingent on a second, offsetting cash transaction.<sup>36</sup>

The Division reviewed 23 inquiries closed during the target period for adequacy. The inquiry files contained appropriate correspondence and documents, including EFP confirmations, records of the futures and cash sides of the transactions, order tickets, pipeline invoice summaries and transfer reports, email messages sent to and received from the EFP participants

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<sup>34</sup> Seventy-two NYMEX inquiries and five COMEX inquiries remained open at the end of the target period. One EFP inquiry was expanded into an investigation, MS-9-02, which was still open at the end of the target period.

<sup>35</sup> Each of the 72 inquiries resulted in a warning or advisory letter. The total number of letters issued was 21 because MSD records each individual EFP transaction involved in an inquiry in a separate entry in the EFP Control Sheet, but combines EFPs between the same parties for purposes of issuing warning or advisory letters.

<sup>36</sup> Prior to September 2001, NYMEX had permitted contingent EFPs between commercial market participants, but barred such transactions between non-commercial market participants. NYMEX reinstated this distinction in May 2002 after further consideration and consultation with market participants. The subsequently-repealed rule amendment involved NYMEX Rule 6.21(D)(2).

by the analyst conducting the inquiry, and copies of any warning or advisory letters issued by MSD. File content demonstrated that MSD conducted adequate inquiry into the bona fides of EFPs, verifying, among other things, the transference of the cash commodity.

As noted above, only seven of the 215 EFP inquiries conducted during the target period involved COMEX commodities. Although the Exchange follows the same procedures for selecting matters for inquiry and conducting inquiries with respect to both NYMEX and COMEX markets, COMEX EFPs appear to have received disproportionately less scrutiny. The percentage of target period volume involved in EFPs was higher at COMEX (3.8%) than at NYMEX (2.9%). However, the percentage of EFP volume scrutinized in EFP inquiries was three times higher at NYMEX (3.4%) than at COMEX (1%), and the percentage of EFP transactions scrutinized was four times higher at NYMEX (0.52%) than at COMEX (0.13%).<sup>37</sup> While the Division recognizes that NYMEX volume far surpasses COMEX volume at the Exchange, the Division nevertheless believes that monitoring for the bona fides of EFPs is equally important for both COMEX and NYMEX markets. The Division is concerned that the disproportionate scrutiny applied to NYMEX EFPs during the target period could indicate that some COMEX EFPs which deserve closer examination may not be receiving it. The Division therefore recommends that MSD review its EFP inquiry procedures and make any modifications necessary to ensure that an adequate number of COMEX EFP inquiries are conducted.

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<sup>37</sup> The disproportionately low number of COMEX EFP inquiries, in fact, reflects a reduction of MSD's usual scrutiny of COMEX EFPs. For example, in the four months prior to the target period, MSD opened 15 inquiries into COMEX EFP transactions involving a broad range of COMEX products.

## 2. EFSs

During the target period, MSD conducted 84 inquiries involving EFSs.<sup>38</sup> Thirteen inquiries were closed and evolved into one investigation. Seventy-one remained open at the end of the target period, including 68 that had been open from six to ten months.

The Division examined all 13 EFS inquiries closed during the review period, and the single EFS investigation. The Division found that MSD generally conducted EFS inquiries in a thorough manner and that the files contained the appropriate correspondence and other relevant documentation to confirm the bona fides of the EFS. The Division also found that the EFS investigation, which remained open at the end of the target period as to one party, was also well documented and thorough.<sup>39</sup> MSD closed the investigation during the target period as to one of the two firms involved and issued a warning letter to that firm after the firm could not furnish a written contractual agreement underlying the swap component of the EFS transactions in question.<sup>40</sup>

With respect to the timeliness of EFP and EFS inquiries and investigations, the Division found that a significant number of cases were open for long periods of time and that the Exchange should take measures to hasten the completion of such matters. More specifically, the Division found that although all of the 138 inquiries closed during the target period had been open from one to six months prior to completion, 51 of the 77 EFP inquiries open at the end of

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<sup>38</sup> All of the EFSs were in natural gas futures. There were no EFS transactions during the target period in Brent crude oil futures.

<sup>39</sup> Investigation MS-3-02.

<sup>40</sup> The other firm involved was facing bankruptcy, and the firm receiving the warning letter had executed the EFSs in an effort to facilitate liquidation of the bankrupt firm's futures positions. After the target period, MSD closed the investigation with respect to the bankrupt firm without further action, since that firm was no longer trading on the Exchange.

the target period had been open for more than one year.<sup>41</sup> In addition, 68 of the 84 EFS inquiries conducted during the target period were open from six to ten months as of the end of the target period. According to the Exchange, some EFP and EFS inquiries remain open for extended periods in order to allow MSD to track trading patterns over time. Additionally, four EFP inquiries open more than one year were kept open on the EFP Control Sheet subsequent to determining the bona fides of the EFPs, because the Exchange was continuing to consider additional issues raised by the transactions. The inquiry files did not indicate any other reason for the length of time that so many inquiries had remained open.

The Division is concerned that allowing such large numbers of inquiries to remain open for long periods may create a backlog of EFP and EFS inquiries which could impede effective Exchange review of such transactions. Also, timeliness problems can diminish deterrence and reduce self-regulatory effectiveness. When inquiries or investigations remain open for extended periods of time, proof can become problematic as memories fade and gaps in documentation become much more difficult to fill. The Division therefore believes that the Exchange should take appropriate steps to improve the timeliness of EFP and EFS inquiries.

## **V. MARKET SURVEILLANCE INQUIRIES, INVESTIGATIONS AND DISCIPLINARY ACTIONS**

As stated above, MSD conducted a total of 422 inquiries during the target period.<sup>42</sup> Two hundred fifteen inquiries related to EFP transactions; 84 involved EFS transactions; and 123 involved position limit violations, inaccurate reporting of open interest and position data, or other matters. The inquiries resulted in a total of 40 warning letters and 15 advisory letters.

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<sup>41</sup> The other 26 inquiries open at the end of the target period had been open for six months or less.

<sup>42</sup> This includes all inquiries handled during the target period, whether opened prior to or during the period and whether closed before the end of the period or still open at its conclusion.

MSD also conducted 18 investigations of member firms, including 14 investigations opened during the target period and four investigations opened prior to the target period. Five of the investigations were generated internally from MSD's market surveillance activities. These involved such matters as exceeding heating oil hedge exemption limits and improper spread trading in crude oil EFPs. Thirteen investigations resulted from Commission referrals, seven of which involved matters already under review by MSD. The 13 matters referred by the Commission involved misreporting of open interest or position data (four investigations) or possible position limit violations (nine investigations).

MSD closed 14 of the 18 investigations during the target period, including two of the four investigations opened prior to the target period, and 12 of the 14 investigations opened during the target period. Four investigations remained open at the conclusion of the target period, including one opened prior to the target period and three opened during the target period.<sup>43</sup>

The Division reviewed the investigation files in all 14 investigations closed during the target period. The Division found that the investigations were thorough and well-documented. Of particular note is the single market surveillance investigation during the target period that uncovered violations defined as major offenses under Exchange rules.<sup>44</sup> That investigation resulted in a significant monetary sanction against a member firm for violations of the Exchange's speculative limit rules. In the course of monitoring the June 2001 heating oil futures position of the subject firm, which was the largest long in the market as the contract approached expiration, MSD detected that on the day prior to the last trading day the member exceeded its hedge exemption position limit. MSD examined the member's trading activity for both that day

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<sup>43</sup> The investigation opened prior to the target period, MS-3-02, as discussed above, has subsequently been closed. The three open investigations commenced during the target period, MS-8-02, MS-9-02 and MS-10-02, had each been open for less than 120 days as of the end of the target period.

<sup>44</sup> Investigation IR-28. A copy of the Investigation Report from this investigation can be found in Appendix 12.

and the final trading day, and found that the member had exceeded its limit by as much as 446 contracts on the next to last trading day and by as much as 1,186 contracts on the final day. The account returned to compliant levels only by selling 600 contracts during the post-close trading session on the last trading day. In addition, the investigation revealed that the member had engaged in a non-competitive trade after the close of trading. After the matter was referred to the Exchange's Business Conduct Committee ("BCC") for disciplinary action, the Exchange accepted a settlement offer that included a fine of \$100,000 and a cease and desist order.

The other 13 closed investigations involved open interest reporting problems or possible spot month speculative position limits violations. As a result of these investigations, MSD issued a total of 11 warning letters and one advisory letter.<sup>45</sup> In one of the four investigations involving possible open interest reporting problems, MSD found that sizeable discrepancies between open interest in natural gas and propane on the last trading day as compared to delivery notices had been caused when clearing members incorrectly reported gross positions and then failed to make timely corrections. The Exchange issued a Notice to Members reminding all clearing members of cutoff times for position reporting and their obligations to ensure accurate reports to the clearinghouse, and also communicated directly with all clearing members referred by the Division concerning their reporting obligations. In the other three open interest reporting investigations, MSD also found position discrepancies resulting from misreporting, in some cases due to members' computer system problems. MSD issued warning letters or advisory letters to the members involved.

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<sup>45</sup> The Exchange issues warning letters for the first occurrence of a speculative position limit violation within a twelve-month period. An advisory letter reminds a member of Exchange rule provisions which may apply to the member's conduct, and puts the member on notice that the Exchange views certain actions as potential rule violations. However, an advisory letter does not cause the incident to count as a violation for purposes of a member's disciplinary history, as a warning letter does.

Timely and accurate reporting of open interest and reportable futures and options positions is critical to the success of the Exchange's market surveillance program, and this gives great importance to the Exchange's monitoring of reporting compliance by clearing members and the adequacy of sanctions when violations are found. The Division found that the Exchange conducted timely and appropriate investigations of open interest reporting issues either uncovered by MSD or referred to it by the Division. The Division believes that warning letters were appropriate for the first time offenders involved in the target period investigations involving reporting problems. Further, the Division notes that MSD initiated a post-target-period investigation of one of the offending clearing members when that member neither responded to the Exchange in a satisfactory manner nor took steps to correct its reporting problem, in order to determine the nature and extent of the clearing member's reporting problems and, if appropriate, take adequate disciplinary action.<sup>46</sup> Lastly, as stated earlier, shortly after the end of the target period, in response to the open interest reporting issues it had uncovered, MSD enhanced its surveillance of potential position reporting problems by instituting a program under which the supervisor responsible for LTRS meets weekly with each MSD analyst to review all large trader exception reports for that analyst's assigned contracts, to ensure that each analyst is keeping the supervisor adequately informed, properly interpreting LTRS data, and taking appropriate action when warranted.

## **VI. CONCLUSIONS AND RECOMMENDATIONS**

The Division found that the Exchange maintains an adequate market surveillance program. The Exchange's market surveillance department is sufficiently staffed and experienced to carry out the Exchange's daily surveillance of market activity. MSD conducts daily

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<sup>46</sup> Investigation MSD-17-02

monitoring of futures and cash market prices, market news, volume, open interest, deliverable supply, clearing member and large trader positions, and data on available supply and demand relating to each Exchange contract. MSD also conducts daily review of position limit and position accountability exception reports and of EFP and EFS transactions.

Relevant data and exception reports are available to and sortable by MSD analysts through automated computer systems, including the Exchange's large trader reporting system. These systems give the Exchange routine access to the positions and trading of market participants and provides an automated means of detecting any violations of position limits or speculative limit exemptions. In addition, MSD conducts frequent telephone interviews with both cash and futures market participants and with industry analysts, in order to compare price data, analyze the supply and demand components of the market, identify unusual or abnormal price relationships, and monitor the delivery process.

The Division also found that the Exchange has an adequate program for investigating possible market surveillance-related rule violations. During the target period, MSD conducted a total of 422 inquiries and 18 investigations. The Division found that inquiry and investigation files were well documented and that appropriate investigative analyses were performed. The Division also found that the Exchange imposed sanctions appropriate to the wrongdoing involved. In the single investigation which uncovered violations defined as major offenses, the Exchange accepted a settlement including a fine of \$100,000 and an order to cease and desist from further similar trading activity. MSD also issued a total of 40 warning letters and 15 advisory letters during the target period.

However, the Division also found two aspects of the Exchange's surveillance of EFP and EFS transactions that warrant improvement. First, although the Exchange follows the same



procedures for selecting matters for inquiry and conducting inquiries with respect to both NYMEX and COMEX markets, COMEX EFPs appear to have received disproportionately less scrutiny during the target period. Only seven of the 215 EFP inquiries conducted during the target period involved COMEX commodities. Although the percentage of target period volume involved in EFPs was higher at COMEX than at NYMEX, the percentage of EFP volume scrutinized in EFP inquiries was three times higher at NYMEX than at COMEX, and the percentage of EFP transactions scrutinized was four times higher at NYMEX than at COMEX. While the Division recognizes that NYMEX volume far surpasses COMEX volume at the Exchange, the Division nevertheless believes that monitoring for the bona fides of EFPs is equally important for both COMEX and NYMEX contracts.

Second, the Division found that although the EFP inquiries closed during the target period were closed in a timely manner, a significant number of the EFP inquiries open at the end of the target period, specifically 51 of the 77 EFP inquiries then open, had been open for more than one year. In addition, 68 of the 84 EFS inquiries conducted during the target period were open from six to ten months as of the end of the target period. The Division is concerned that allowing such large numbers of EFP and EFS inquiries to remain open for long periods may create a backlog which could impede effective Exchange review of such transactions and diminish deterrence.

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

- **Review its EFP inquiry program and implement modifications necessary to ensure that an adequate number of COMEX EFPs are scrutinized, and improve the timeliness of EFP and EFS inquiries.**