FOLLOW-UP RULE ENFORCEMENT REVIEW
OF THE
CHICAGO BOARD OF TRADE

I. INTRODUCTION

The Division of Trading and Markets ("Division") has completed a follow-up rule enforcement review to its June 30, 2000 rule enforcement review ("2000 Review") of the Chicago Board of Trade ("CBT" or "Exchange").[1] The 2000 Review focused on the Exchange's trade practice surveillance and disciplinary programs for the period of October 1, 1998 through September 30, 1999. Although the Division found that the Exchange maintained adequate trade practice and disciplinary programs, the Division's 2000 Review set forth several recommendations designed to further enhance the CBT's self-regulatory procedures.

With respect to the Exchange's trade practice surveillance program, the Division recommended that the Exchange improve the timeliness of its investigations, expand investigations when serious allegations of wrongdoing are made, and take cognizance of the trading activity of members whose cases are referred to a disciplinary committee. With regard to the Exchange's disciplinary program, the Division recommended that the Exchange issue meaningful penalties in instances of members improperly changing settlement prices or disclosing orders, refer multiple instances of violations relating to errors and mishandling of orders to an appropriate disciplinary committee, and take steps to ensure that all members and their employees understand CBT's electronic trading rules.

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[1] The 2000 Review can be found in Appendix 1.

The Exchange responded to the 2000 Review by letter dated September 15, 2000 ("2000 Response"), outlining the initiatives it would take to implement the Division's recommendations.[2] In order to evaluate the Exchange's progress in implementing the recommendations, the Division conducted this follow-up review. The target period for the follow-up review is January 1 through June 30, 2001. As part of the review process, the Division examined computer reports generated by the Exchange's automated trade practice surveillance system and other documents used routinely for surveillance, trade practice investigation and disciplinary logs, selected trade practice investigation and disciplinary action files, minutes of disciplinary committee meetings, and other pertinent documents.

For each 2000 Review recommendation, this report presents a brief description of the findings that led to the recommendation, the Exchange's response to the recommendation, and the Division's analysis of the Exchange's progress in implementing the recommendation.[3] The Division gave the CBT an opportunity to review and comment on a draft of this report on January 7, 2002. On January 15, 2002, Division staff conducted an exit conference with CBT compliance officials to discuss the report's findings and recommendation.

[2] The 2000 Response can be found in Appendix 2.

[3] The Division's 2000 Review recommendations are italicized in bold print.

II. TRADE PRACTICE SURVEILLANCE PROGRAM

1. Focus substantial attention on timely completion of investigations in order to achieve significant improvements in timeliness. Additionally, CBT must file a quarterly report with the Division, beginning in October 2000, which details the timeliness of investigations closed during the previous quarter.

In the 2000 Review, the Division found numerous investigations that were open for more than one year, and in some instances, in excess of two or even three years. One hundred and forty-four, or nearly 45 percent of the investigations closed during the target period, were open for more than one year, nine were open more than two years, and two were open more than three years. Although several of the investigations open for more than one year were complex in nature and, therefore, justifiably took a longer period of time to complete, the Division found that long periods of dormancy and undue delays in supervisory review were major factors in delaying the closure of the oldest investigations. In addition, the Exchange's Office of Investigations and Audits ("OIA") experienced unusually high rates of employee turnover prior to and during the 2000 Review target period, which also contributed to delays.[4]

In its 2000 Response, the Exchange acknowledged that its investigation timeliness required improvement, described the various factors that affected timeliness, and set forth the latest steps it has taken to address the issue. First, in March 2000, the Exchange adjusted the grade levels of OIA positions. These adjustments resulted in substantive compensation increases for all levels of staff to bring their compensation more closely in line with comparable positions elsewhere. Second, the Exchange reallocated regulatory

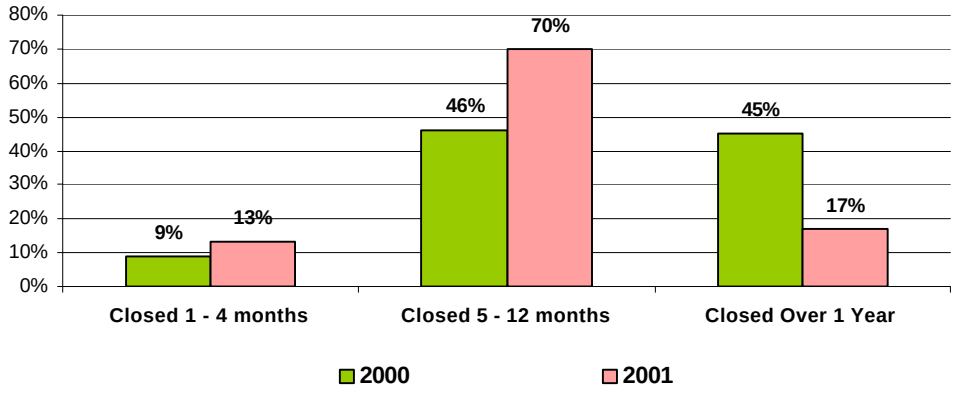
[4] OIA experienced turnover rates of approximately 25 percent during the 2000 Review target period, and 37 percent during the 12 months preceding the target period. The CBT, as a whole, had an average staff turnover rate of 15 percent. OIA has reported that staff turnover levels decreased to 17 percent from June 2000 to August 2001.

resources after modifying certain programs that yielded few regulatory benefits relative to their costs. This allowed increased time for more productive investigative work. Finally, OIA streamlined its procedures for closing investigations. Under the new procedures, an investigation is officially closed on CBT's logs once a manager has reviewed and approved an investigator's closing memorandum. The Exchange stated that these steps have resulted in substantial improvement in its investigation timeliness. Specifically, the Exchange noted that as of the date of its 2000 Response, the Exchange had no cases outstanding in excess of a year and only eight cases outstanding in excess of 10 months.

During the follow-up target period, the Division found continued improvement in investigation timeliness. OIA closed 84 investigations during the target period, of which 14, or 17 percent, had been open for more than one year. Although this represents an increase in the number of investigations open more than one year since CBT's 2000 Response, the percentage of those open more than one year compares favorably to the almost 45 percent identified during the 2000 Review target period.[5] In addition, 59 of the 84 investigations, or 70 percent, had been open between five months and one year, and the remaining 11 investigations had been open for four months or less. Thus, the number of investigations that were open for longer than one year decreased by 62 percent from 2000 to 2001, while investigations that were closed between five and 12 months increased by 52 percent. Figure 1 below illustrates these results:

[5] The Division notes that timeliness could be further improved by OIA continuing to focus on hastening supervisory review. The Division found that the length of supervisory review ranged from 48 to 264 days for at least four of the 14 investigations closed during the follow-up review target period that were open for more than one year. *See* 00-TOO-07, 00-TPI-13, 99-TPI-63, and 00-TPI-25 in Appendix 3.

Figure 1: Comparison of Length of Investigations Closed during the 2000 and 2001 Target Periods



The Division reviewed 27 of the 84 investigations closed during the current target period, including five investigations that were referred to a disciplinary committee. The Division found that the Exchange continues to conduct thorough investigations, several of which were complex. For example, some of the investigations reviewed by the Division not only involved detailed analysis of outright futures trades, but also involved analysis of complicated option trades and spreads.[6] In addition, investigations appeared to be well documented and investigation reports were sufficiently detailed.

2. Widen investigations appropriately when serious allegations of wrongdoing are made.

This recommendation stemmed from an investigation in the 2000 Review which the Division believed should have been expanded to other pits based on information obtained during an interview of the respondent.[7] OIA determined that on several occasions over a 15-day period, the Vice-Chairman of the Wheat Options Pit Committee settled Wheat option prices out-of-line with their fair market value. This was done in

[6] *See* 01-INV-14 and 00-TPI-39 in Appendix 4.

order to enhance the equity in his personal trading account with regard to several hundred option contracts. In doing so, the Vice-Chairman overrode the Exchange's automated Option Settlement Verification Program ("OSVP"), which identifies discrepancies between a pit committee's settlement recommendations and certain theoretical values. Discrepancies are supposed to be resolved by a pit committee representative either modifying the settlement price to conform to the parameters given by the OSVP or justifying why the option should settle outside the parameters.

In OIA interviews, the Vice-Chairman of the Wheat Options Pit Committee admitted that he had marked settlement prices to benefit his position, but claimed that this practice had been "going on for a long time" and "occurs routinely in all pits." Notwithstanding this serious allegation, OIA did not widen its investigation to include an examination of settlement prices in other option pits. OIA did, however, refer the Vice Chairman to a disciplinary committee for possible violations of the CBT's procedures governing option settlement prices.[8]

In its 2000 Response, the Exchange stated that it disagreed with the Division's interpretation of the scope of the Vice Chairman's statement regarding the practice of marking the close. Nonetheless, the Exchange agreed to initiate a study to examine a sampling of settlement prices in other option markets, as requested by the Division in the 2000 Review. In its study, OIA reviewed option settlement prices for nine contracts during the week of November 27, 2000. These contracts included options on Corn, Soybeans, Wheat, Oats, Soybean Meal, Soybean Oil, Treasury Bonds, and Ten- and Five-

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[7] 99-INV-11.

[8] As discussed below in Section III.1., the Vice Chairman received only a written reprimand, which the Division cited in the 2000 Review as an inadequate sanction given the seriousness of the violation.

Year Treasury Notes. The week of November 27 was selected based on trading volume and price volatility relative to other weeks during that month.

The study found that more than 99 percent of the nearly 2800 option strikes settled during that week settled within OSVP parameters. OIA examined all settlements that fell outside of OSVP parameters and additionally did not find any modified settlement prices that were out-of-line with fair market value. In several instances, the Exchange found that modifications brought the settlements more in line with theoretical value. However, in reviewing the settlement modification logs, OIA found several instances in which the reason set forth in support of the change or justification did not appear to correspond to the underlying activity, or in which the member requesting the change was not identified.[9] For example, the cited reason for adjusting the July 460 Soybean put settlement on November 27 and 29 was to bring the conversion into line, but because there was no call settlement for that strike, that reason could not consequently apply.

Based on these findings, and in response to the Commission's July 2001 Report on Lessons Learned From the Failure of Klein & Co. Futures, Inc. ("Klein Report"), in which, among other things, exchanges were requested to develop and maintain programs to review settlement prices to determine if they are reasonable, the CBT has taken the following steps to ensure the integrity of its option settlement procedures and option settlement prices. First, OIA met with the Exchange's option pit committees and appropriate staff to remind them of the importance of ensuring the accuracy, consistency,

[9] The Exchange's settlement modification procedure requires that the authorizing member of the pit committee record the justification for any change or modification to the settlement price, along with his or her member acronym, in the modification log. The requesting member's acronym should also be identified.

and integrity of all option settlements, including those not actively traded, and that the OSVP program is implemented correctly in all instances. In particular, OIA reminded members and staff that all discrepancies outside the OSVP parameters must either be modified or justified in an accurate and sufficiently detailed manner on the settlement modification logs.

Second, OIA has incorporated a quarterly review of option settlement prices into its routine surveillance program. The program is intended to ensure that OSVP procedures are complied with, and that patterns that may be indicative of an attempt to manipulate the settlements are identified and investigated. The program was implemented in November 2001 and generally entails reviewing each option that settles outside the OSVP parameters to verify that the settlement was justified and is supported by relevant data. In the event of a possible pattern of discrepancies or unsubstantiated justifications, investigators are instructed to review daily trade data and large trader data to assess whether the settlement price may have been marked inappropriately. As part of this new effort, OIA is seeking to database the relevant OSVP output to allow staff to query the data across trade dates.

3. Take Cognizance of Trading Activity of Members Whose Cases are Referred to Disciplinary Committees

In the 2000 Review, the Division identified a situation that involved a member engaging in apparent prearranged and noncompetitive trading during the lengthy period of time that a case involving the same member and similar illegal trading activity was pending before a disciplinary committee.[10] The Division, during the course of its routine

[10] This investigation, 97-INV-3, involved two members of the same broker group. One member was ultimately fined $100,000 and suspended for 30 days, while the other member was fined $20,000 and suspended for 20 days.

oversight activity, discovered similar potential violations using the Commission's Exchange Database System. Because the Division believes that the facts that led to the issuance of charges against the member also constitute reasonable grounds to suspect that the member might engage in further illegal activity, the Division recommended that CBT take cognizance of the trading activity of those members whose cases are referred to a disciplinary committee.

In its 2000 Response, the Exchange stated that OIA staff are encouraged to take into account the prior investigative histories of members in conducting trade practice oversight. In the course of conducting this follow-up review, the Division did not identify any similar situations.

III. DISCIPLINARY MATTERS

1. Issue meaningful sanctions, including appropriate fines and/or suspensions from trading, where members improperly change settlement prices or disclose orders.

The Division found in the 2000 Review that in most cases the Exchange imposed adequate sanctions. However, the Division identified two cases in which it questioned the sufficiency of the sanctions. The first case was the matter that involved the Vice-Chairman of the Wheat Options Pit Committee, discussed above.[11] By overriding the Exchange's automated OSVP, the Vice-Chairman used his position to enhance the equity in his personal trading account. The settlement offer accepted by the Floor Governors Committee ("FGC") included a written reprimand, but did not include a monetary penalty or suspension from the trading floor. Considering the nature of the violation and the

[11] *See* Section II.2.

Vice-Chairman's misuse of his position, the Division believed that a monetary penalty and/or suspension from the trading floor was warranted.

The second case involved a member/phone clerk who was charged with disclosing stop prices on two resting orders to another customer.[12] The member was fined $2,500. The Division believed that this sanction failed to adequately address the seriousness of the violation, and may not serve as an effective deterrent. By disclosing order information, the member jeopardized the integrity of the market and disregarded his duty to his customers. The Division believed that a more severe sanction also was appropriate in this instance.

In its 2000 Response, the Exchange stated that the FGC has been apprised of the Division's recommendations and that the committee will keep them in mind when considering future, similar cases. The Exchange also stated that the FGC believed that both settlements cited by the Division were reasonable when evaluated in light of the facts and circumstances of each case. The Exchange explained that the preliminary charges against the Vice-Chairman of the Wheat Options Pit Committee included the imposition of a $5,000 fine. However, in settling the matter, the Vice-Chairman accepted a formal reprimand and resigned his Pit Committee position. The Exchange further explained that in accepting the settlement offer, the FGC took into consideration the respondent's six-year history of recommending settlements without a problem, his candor in his interviews with OIA, and his uncontroverted claim that he was willing to buy the options at the prices which he bid them at the close and at which he recommended that they be settled.

[12] 98-INV-20.

With respect to the case involving the member who disclosed the stop orders, the Exchange stated that the FGC took into account the context and result of the disclosure, the fact that the evidence indicated that the disclosure was an isolated event, and that the individual did not have a prior disciplinary history. The Exchange also noted that, in conjunction with this matter, the employing member firm was fined $10,000 for its failure to supervise the member/phone clerk.

In the current target period, the Division found that none of the ten disciplinary cases closed raised similar concerns respecting the adequacy of sanctions. Sanctions were levied in six of the ten cases against a total of eight individuals.[13] The sanctions included monetary penalties totaling $15,000 (ranging from $500 to $8,500) levied against four individuals for noncompetitive trading, mishandling of error trades, and failure to acknowledge an executed trade. Three individuals, two of whom also were fined, were suspended for a total of 14 business days. In addition, one individual received a reprimand and paid $42,875 in restitution for allocating trades in other than an equitable manner, and two individuals were reprimanded for mishandling error trades. In the four remaining disciplinary cases closed during the follow-up review target period, the FGC did not find sufficient evidence to warrant finding a violation of Exchange rules.

[13] *See* 00-INV-11, 00-INV-07, 00-INV-15, 00-INV-16, 00-INV-18, and 00-INV-23 in Appendix 5.

2. Refer cases of multiple instances of violations relating to errors and mishandling of orders, absent mitigating circumstances, to the appropriate disciplinary committee for consideration of sanctions, rather than issuing repeated reminder letters.

The 2000 Review noted the Division's concern regarding the Exchange's enforcement of CBT Rule 350.04, which pertains to outtrades, errors and the mishandling of orders.[14] The Division had identified numerous instances in which repeat offenders of the rule were not referred to a disciplinary committee, but instead were issued OIA staff warning letters. Specifically, during the 2000 Review target period, 43 brokers and seven firms received more than one warning letter concerning violations of Rule 350.04. The Division opined that members or member firms who violate substantive rules that address potential customer fraud should not be issued more than one reminder letter in a 12-month period, absent mitigating circumstances. Rather, the Division believed that such members should be referred to a disciplinary committee for consideration of charges and appropriate penalties.

In its 2000 Response, the Exchange asserted that the majority of reminder letters issued during the target period for violations of Rule 350.04 were issued for technical violations of the rule, such as placing an error trade into a personal trading account rather than an error account, or for isolated, improper recordkeeping. The Exchange also asserted that because Rule 350.04 has different technical requirements, many of the reminder letters that were issued to the same members were issued for different

[14] Rule 350.04 provides generally that if a customer outtrade cannot be resolved, the floor broker can re-execute the order in the market and adjust the customer by check if the re-execution price is worse than the original execution price, or assign the opposite side of the customer's trade to his or her error account at the execution price. The rule also provides that the assignment process can be used in the event a floor broker erroneously executes a customer order or otherwise mishandles an attempt to execute a customer order. However, the rule may not be used to clear unfilled or under filled orders, orders that were erroneously executed in the wrong contract month, strike price, put vs. call or side of the market, or price outtrades.

requirements of the rule, and thus, the members were not truly repeat offenders. Further, CBT stated that it had referred, and would continue to refer, repeated, substantive violations of Rule 350.04 and all cases involving customer fraud to the FGC.[15]

The Division concurs with the Exchange that Rule 350.04 violations should be examined to determine whether the violation was procedural or substantive in nature, and that substantive violations should be referred to a disciplinary committee. However, a member who repeatedly fails to comply with the procedural requirements of an Exchange rule should also be referred to a disciplinary committee for consideration of further action. While the Division acknowledges that in certain instances reminder letters for procedural violations of a rule may be appropriate, the continued issuance of such letters may not curb the violative activity.

3. Take appropriate steps, including issuance of notices to members, to ensure that all members and their employees understand Exchange rules relating to electronic trading.

In reviewing Project A disciplinary cases closed during the 2000 Review target period, the Division found an apparent pattern of misunderstanding or confusion on the part of members and member firms concerning some of the Exchange's electronic trading rules.[16] For example, the Division identified three cases involving trade entry by terminal operators other than the operator logged on to the system. In one of these cases, the member whose User ID was being improperly used by others stated that he knew that

[15] The Exchange explained that during the 2000 Review target period, OIA had referred four Rule 350.04 cases that involved minor violations to the FGC. Subsequently, the FGC directed OIA to administratively issue reminder letters for matters involving minor infractions of Rule 350.04 that did not rise to a level warranting formal disciplinary action.

[16] In August 2000, the Exchange replaced its Project A electronic trading platform with the a/c/e electronic trading platform.

this was a rule violation and knew that it was occurring, but believed that this practice was necessary to secure the proper fill price for the customer.

The Exchange stated in its 2000 Response that the growth in electronic trading creates significant transition issues on many fronts for members and member firms. The Exchange also explained that while it currently provides comprehensive training for new system users, routinely addresses regulatory issues at user group meetings, and issues periodic notices and bulletins regarding specific electronic trading rules, it would endeavor to be more proactive in educating users, particularly when its investigative findings indicate consistent violations of a particular rule by different parties.

In this regard, during the follow-up target period, CBT issued several notices to members reminding them of their obligations with respect to specific electronic trading rules. For example, in conjunction with the conclusion of an electronic trading investigation involving misuse of User IDs and passwords, the Exchange issued notices to all members reminding them of their obligations concerning the proper use of User IDs. Among other things, the notice stated that each direct user of a/c/e is required to utilize only his or her designated User ID, and that individual members, proprietary traders of member firms, and all employees and agents of member firms must be assigned and utilize individual User IDs. The notice also emphasized that firms were responsible for monitoring and verifying the accuracy of all User ID information reported to the Exchange, and that the audit trail for any proprietary order routing system must meet Exchange and Commission requirements. In addition, the Exchange issued notices concerning, among other things, the prohibition against the exercise of discretion by a

non-member terminal operator in the placing of an order, pre-execution communications, and keyboard functionality in the order entry process.

In reviewing CBT's disciplinary cases for the follow-up target period, the Division identified one firm that received two warning letters within a four-month period regarding terminal operators placing orders using User IDs other than their own.[17] The letters reminded the firm of its obligation to supervise its terminal operators' compliance with Exchange rules and that any violation of Exchange rules by a terminal operator may be considered a violation by the firm. The second reminder letter concluded by stating that any other violation of this nature "will be referred to the Floor Governors Committee for disciplinary action." The Division believes that effective enforcement of the Exchange's rules would necessitate that any additional similar violations by the firm be referred to the FGC, as suggested in the reminder letter, for the imposition of sanctions.

IV. CONCLUSIONS AND RECOMMENDATIONS

In reviewing the Exchange's trade practice surveillance and disciplinary programs, the Division finds that CBT generally has implemented the recommendations set forth by the Division in its 2000 Review. Most notably, CBT has improved its timeliness with respect to completing investigations. Of the 84 investigations closed during the follow-up review target period, 17 percent had been open for more than one year, as compared to the 2000 Review, when 45 percent of the investigations closed had been open for longer than one year. The Division believes that the timeliness of the

[17] OIA issued the first warning letter on March 16, 2001 (00-PJA-04). The second warning letter was issued on July 2, 2001 (00-PJA-06).

Exchange's investigations could be further improved by OIA's continued focus on hastening supervisory review.

The Exchange also expanded an investigation of option settlement prices at the request of the Division by conducting a study of settlements across certain option markets. Based on the study's findings, and in response to the Commission's Klein Report, the Exchange reminded option pit committees and appropriate staff of the importance of ensuring the accuracy of all option settlements, and of their responsibility to document adequately the reasons for modifications to settlement prices. Additionally, the Exchange has incorporated a quarterly review of option settlement prices into its routine surveillance program.

The Exchange also issued several notices to its members reminding them of their responsibilities concerning specific electronic trading rules and practices. These notices related to, among other things, the misuse of User IDs and passwords, the prohibition against the exercise of discretion by a non-member terminal operator in the placing of an order, and pre-execution communications.

Finally, the Division recommended in the 2000 Review that multiple instances of violations relating to errors and mishandling of orders, absent mitigating circumstances, be referred to a disciplinary committee rather than OIA issuing repeated reminder letters. This recommendation related specifically to the Exchange's enforcement of Rule 350.04. The Exchange responded that most reminder letters that had been issued for violations of the rule were for procedural rather than substantive violations, and that substantive violations were routinely referred to a disciplinary committee. While substantive violations should be referred to a disciplinary committee, a member who continues to

violate procedural requirements, notwithstanding the receipt of several reminder letters, should similarly be referred to a disciplinary committee. In this manner, the committee can then impose more meaningful remedial action against the member to deter future violations.

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

- **Refer members who have received reminder letters for previous violations of procedural requirements to a disciplinary committee for consideration of more meaningful remedial action.**