

**RULE ENFORCEMENT REVIEW
OF THE
BROKERTEC FUTURES EXCHANGE**



**Division of Market Oversight
September 30, 2003**

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RULE ENFORCEMENT REVIEW OF THE BROKERTEC FUTURES EXCHANGE

I. INTRODUCTION

The Division of Market Oversight (“Division”) has completed a rule enforcement review of the market surveillance, audit trail, trade practice surveillance, and disciplinary programs of the BrokerTec Futures Exchange (“Exchange” or “BTEX”), for compliance with related core principles under Section 5(d) of the Commodity Exchange Act (“Act”), as amended by the Commodity Futures Modernization Act of 2000 (“CFMA”), and Part 38 of the Commission’s regulations. The review covers the target period of November 30, 2001 to November 30, 2002, the first year of the Exchange’s operation.¹

The core principles focused on in the review include 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; Core Principle 5, *Position Limitations or Accountability*, which relates to an exchange’s program for enforcing its speculative position limits and position accountability rules; Core Principle 10, *Trade Information*, which relates to an exchange’s audit trail program for the recording and safe storage of trade information in a manner which enables prevention of customer and market abuses and enforcement of exchange rules; and Core Principles 2, *Compliance With Rules*, and 12, *Protection of Market Participants*,

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

which relate to an exchange's program for enforcing its rules, conducting disciplinary proceedings, and protecting market participants from abusive practices. Appendix B to Part 38 provides acceptable practices for demonstrating compliance with these core principles.

For purposes of this review, Division staff interviewed officials and staff from the Exchange's Compliance Department ("Compliance"), and the Compliance Department of the National Futures Association ("NFA"), which is responsible for conducting the Exchange's regulatory compliance operations on a contract basis.² The Division also reviewed numerous documents used by Compliance and NFA in carrying out the Exchange's self-regulatory responsibilities. These documents included, among other things, the following:

- computer reports generated by NFA's automated surveillance systems and other documents used in market and trade practice surveillance;
- files and records concerning contract expirations and position accountability enforcement;
- NFA's inquiry and investigation log;
- files and records concerning market surveillance and trade practice inquiries and investigations closed or conducted during the target period;
- NFA's written guidelines for trade practice and market surveillance;
- provisions of the regulatory services agreement between BTEX and NFA which describe the scope of the self-regulatory services performed for BTEX by NFA; and
- minutes of all meetings of the BTEX Board of Directors during the target period.

The Division provided the Exchange an opportunity to review and comment on a draft of this report on September 11, 2003. On September 16, 2003, Division staff conducted an exit conference with Exchange officials to discuss the report's findings and recommendations.

² A copy of the March 31, 2003 transcript of the interview can be found in Appendix 1.

II. SUMMARY OF FINDINGS AND RECOMMENDATIONS

A. Findings

- BTEX maintains an adequate market surveillance program. NFA conducts daily monitoring of futures and cash market prices, market news, volume, open interest, and clearing member and large trader positions relating to each Exchange contract. NFA also conducts daily review of position accountability exception reports, and reviews trading information to identify unusual or abnormal price relationships.
- NFA's surveillance systems, including the large trader reporting function and trader profile function, make relevant data and exception reports available to and sortable by NFA analysts. These systems give NFA and BTEX routine access to the positions and trading of market participants.
- BTEX maintains adequate audit trail and recordkeeping programs. The BTEX audit trail includes a complete electronic record of all entries into its matching engine and the details of every trade, allowing the Exchange to reconstruct trading efficiently and effectively. In addition, any changes to orders are automatically timed and identified. BTEX also has adequate procedures in place for safe storage of audit trail data.
- BTEX maintains an adequate trade practice surveillance program. NFA uses various exception reports to identify possible trading violations, and monitors trading on a real-time basis. NFA opened 11 inquiries and three investigations during the target period, the majority involving possible wash trades. Inquiries and investigations were generally thorough, well-documented, and completed in a timely manner. In one investigation, NFA reviewed related cash market positions, but did not identify the specific cash market positions that were being hedged by the block trades in question in order to confirm the stated economic purpose of the transactions. The three investigations were closed with findings of no violations, and one inquiry resulted in the issuance of a reminder letter.
- The Exchange does not review an adequate number of block trades or exchanges of futures for physicals ("EFP") transactions to ensure member compliance with relevant Exchange rules. NFA's surveillance procedures resulted in only one EFP inquiry and one block trade inquiry during the target period. In addition, one block trade investigation resulted from a Division referral. NFA did not select any block trades or EFPs for review on a random basis. Without a program of random review, block trades and EFPs that do not appear anomalous, but may be in violation of Exchange rules, could escape scrutiny.

B. Recommendations

- **The Exchange should review its block trade and EFP rule enforcement programs and implement modifications necessary to ensure examination of an adequate number of randomly selected block trades and EFPs for compliance with Exchange rules.**

III. BACKGROUND

A. Exchange Overview

BTEX was approved by the Commission as a designated contract market on June 16, 2001 and began trading on November 30, 2001. The Exchange offers electronic trading of futures contracts in 30-Year U.S. Treasury Bonds and 5-Year and 10-Year U.S. Treasury Notes.³ During its first year of operation, corresponding to the target period, BTEX volume totaled 1,979,409 contracts. On a monthly basis, BTEX's volume increased from 76,773 contracts in December 2001 to 430,888 contracts in November 2002, the end of the target period.

Most of BTEX's members are institutional participants, including global financial institutions and banks, securities firms, futures commission merchants, and proprietary trading firms. As of the end of the target period, the Exchange had approximately 30 members. BTEX trades are cleared through the BrokerTec Clearing Company ("BCC"), which guarantees all BTEX trades. Under the terms of a contract between BTEX and the Board of Trade Clearing Corporation ("BOTCC"), BOTCC processes all BTEX trades for clearing. As noted earlier, NFA provides BTEX's regulatory compliance services, including trade practice and market surveillance, and investigation and prosecution of disciplinary matters, as well as auditing and financial surveillance.

All trades on the Exchange are processed electronically through the BTEX Trading System ("Trading System"), a fully automated, electronic trading system customized for BTEX's use from the OM CLICK Exchange System developed by OM Technology AB ("OM"), an international provider of exchange systems and support. The primary Trading System host is

³ The specifications of BTEX futures contracts on 30-Year U.S. Treasury Bonds and 10-Year U.S. Treasury Notes are identical to the specifications for Chicago Board of Trade's ("CBT") futures contracts on those instruments. The specifications of BTEX futures contracts on 5-year U.S. Treasury Notes are identical to the specifications of the parallel CBT futures contracts, except that the tick size for the BTEX contract is 1/4 of 1/32nd rather than 1/2 of 1/32nd.

located at OM's facility New York City, where OM also conducts continuous monitoring of all Trading System processes. A complete back-up trading system is located in a separate facility located in Jersey City, New Jersey. If any component of the primary Trading System fails, the corresponding component of the back-up system would automatically take over the function involved within two minutes. If the entire primary Trading System were to fail, BTEX anticipates that full trading capability would be switched to and available on the back-up system within five minutes. Members communicate with the Trading System over a dedicated network provided by OM. To ensure member access to the back-up system if needed, members have separate communications lines to both systems.

Orders can be entered into the Trading System through a proprietary front-end application, or through any order routing system or other computer program capable of communicating with the Trading System through BTEX's Application Programming Interface. The Trading System executes orders in accordance with an algorithm that gives first priority to orders at best prices, and then gives priority among orders at the same price on the basis of time of entry into the Trading System.

Under BTEX rules, orders may be entered into the Trading System only by Exchange members and authorized employees of members or their affiliates ("Authorized Traders"), or through a member's automated order routing system.⁴ During the target period, more than 95% of the orders entered into the Trading System consisted of proprietary trading by members for their own accounts, while less than five percent of all trades constituted retail customer business.

⁴ BTEX Rule 403(b)(iii).

B. Compliance Staff

Market and trade practice surveillance of BTEX are conducted principally by three NFA Trade Practice and Market Surveillance Group (“TPMS Group”) staff members: the Senior Manager for Trade Practice/Market Surveillance, the Senior Manager for Market Services/Technology, and a Manager for Trade Practice/Market Surveillance.⁵ The TPMS Group also includes an Administrative Assistant. The two Senior Managers report to NFA’s Senior Vice President for Compliance.⁶ NFA has implemented a cross-training program through which six additional NFA staff members normally assigned to other duties have been trained for trade practice and market surveillance, and these staff members are available to assist with compliance services for BTEX if future increases in volume require additional staff. The BTEX Compliance Department consists of the Head of Compliance, who is one of the five officers of the Exchange.⁷ The Head of Compliance is responsible for liaising with NFA on compliance matters.

IV. MARKET SURVEILLANCE

A. Daily Market Surveillance Activities

In order to detect potential manipulations and price distortions, and to ensure the orderly liquidation of expiring contracts, NFA conducts daily monitoring of prices, volume, open interest, clearing member and large trader positions, and market news for all contracts traded on

⁵ The Senior Manager for Trade Practice/Market Surveillance has more than seven years of regulatory experience in compliance and market surveillance; the Senior Manager for Market Services/Technology has more than 17 years of regulatory experience in compliance and market surveillance; and the Manager for Trade Practice/Market Surveillance has more than six years of regulatory experience in compliance and market surveillance, and 15 years of experience in futures trading.

⁶ The Senior Vice President has more than 23 years of regulatory experience in compliance and market surveillance.

⁷ The Head of Compliance, an attorney, who reports to BTEX’s General Counsel and Chief Operating Officer, has approximately 30 years of experience with respect to regulation of futures and securities.

BTEX. TPMS Group staff use several online quotation systems and computer-generated reports for this purpose.

The principal computer tool used by NFA for surveillance of BTEX markets is an NFA computer program called the Trade Analysis and Profiling System (“TAPS”). TAPS gives NFA staff access to the Exchange’s historical price record, and provides alerts whenever upward or downward price moves exceed preset parameters.⁸ In addition, NFA uses a third-party vendor for real-time news and cash market prices, and to chart historical price relationships and spread relationships for the Exchange’s various markets. The third-party vendor also enables NFA staff to chart changing relationships between BTEX prices and prices for both electronic and pit-traded contracts at the CBT that involve similar underlying government securities. Further, NFA conducts daily monitoring of the basis relationship between each BTEX contract and the corresponding cash market, the price relationship between each BTEX contract and any related contracts, and the spread relationship between different months in each BTEX contract. These spread relationships are tracked through use of a terminal provided by another third-party vendor. This third-party vendor’s terminal alerts NFA whenever relationships between BTEX and cash market prices or between BTEX and CBT prices differ by more than two standard deviations from a 62-day moving average. Finally, NFA also monitors prices and trading on a real-time basis periodically during the trading session and on the open and close of trading.

Volume and open interest are also monitored on a daily basis. NFA staff review the previous day’s trading volume and open interest for each Exchange contract through TAPS. TAPS provides a daily recap of the previous day’s trading, and enables staff to sort volume and

⁸ The parameters of this exception report are described in paragraph 9(D) of the Schedule A, *Scope of Regulatory Services*, incorporated in the regulatory services agreement between BTEX and NFA. A copy of Schedule A can be found in Appendix 2.

open interest data by contract, trade type, clearing member, large trader or other market participant. As noted above, historical volume data is also available through TAPS. TAPS sends a “management alert” to staff if any trader has a percentage of either volume or open interest beyond preset parameters. TAPS also maintains an electronic record of which NFA staff member reviewed each alert, and what action, if any, was taken in response. Finally, TAPS enables NFA to view trade and volume information by clearing member or by firm, and to rank positions in each contract by size.

NFA heightens its surveillance as BTEX contracts approach their expiration dates. The large trader screen in TAPS, which NFA staff review daily, highlights the expiration date for each contract. During the month prior to expiration, staff pay particular attention to large trader open interest and volume in light of the knowledge of the firms’ and traders’ trading patterns maintained in the TAPS trader profiles module. TAPS also produces exception reports which alert NFA whenever basis relationships do not narrow as expected with the approach of a contract expiration. There were no problematic contract liquidations during the target period.

B. Large Trader Reporting System

BTEX’s large trader reporting system is an integrated function of TAPS. TAPS has preset alerts which inform NFA staff whenever a trader has met the threshold for large trader status.⁹ NFA then obtains a CFTC Form 102 from the trader, and enters the information into the TAPS list of large traders. The large trader function in TAPS generates large trader reports which are reviewed each day by NFA staff. TAPS aggregates all positions held by related parties. Once this information is compiled, NFA monitors large trader positions for

⁹ The reportable levels for BTEX products, established in Commission Regulation 15.03, are as follows: 800 futures contracts on 5-Year U.S. Treasury Notes; 1,000 futures contracts on 10-Year U.S. Treasury Notes; and 1,000 futures contracts on 30-Year U.S. Treasury Bonds.

concentrations of ownership and potential collusive or concerted activity by market participants. If it appears that any one trader or controller has a concentration in a given commodity, NFA procedures call for NFA staff to contact the trader or controller to determine the reason for the concentration.

TAPS also enables NFA staff to view complete information regarding each large trader's trading history at any time. As with other reports, TAPS maintains an electronic record of which NFA staff member reviewed each large trader report, and a record of staff notes concerning what action if any was taken in response. NFA also maintains daily BTEX large trader data in an Excel spreadsheet, which staff use to track day-to-day changes in large trader positions.

C. Position Accountability

BTEX rules establish position accountability levels for each of the futures contracts currently traded at the Exchange which, as noted above, include futures contracts on 30-Year U.S. Treasury Bonds and 5-Year and 10-Year U.S. Treasury Notes.¹⁰ The only speculative position limit established in Exchange rules is the limit imposed with respect to futures contracts on 2-Year U.S. Treasury Notes, which have not been listed for trading.¹¹

BTEX rules require any person owning or controlling a combined net long or net short futures position which exceeds the applicable position accountability level to provide information to BTEX at its request on the nature of the position, trading strategy, and any

¹⁰ The position accountability levels (net long or net short in all delivery months combined) for BTEX futures contracts, established in BTEX Rules 302 (e), 303(e), and 304(e), are as follows: 7,500 futures contracts on 5-Year U.S. Treasury Notes; 7,500 futures contracts on 10-Year U.S. Treasury Notes; and 10,000 futures contracts on 30-Year U.S. Treasury Bonds.

¹¹ BTEX Rule 301(e).

hedging involved.¹² The rules also give the Exchange discretion to bar further increase of the position.

NFA monitors compliance with BTEX position accountability rules through the large trader function in TAPS. The large trader data monitored each day by NFA includes the position accountability levels applicable to each trader's positions. TAPS has exception reports which alert NFA whenever a BTEX trader reaches or exceeds a position accountability threshold.

Exchange procedures applicable when a trader reaches or exceeds a position accountability level call for NFA to notify the BTEX Compliance Department by phone or e-mail. BTEX's Head of Compliance then contacts the trader or member involved by telephone or e-mail for information on the nature of the position, the trading strategy involved, and the member's financial ability to maintain the position. After receiving the requested information, the Head of Compliance determines whether the Exchange needs to impose any conditions with respect to the size of the position. If conditions are imposed, the Head of Compliance notifies NFA, and NFA conducts continued monitoring to ensure ongoing compliance with the conditions. During the target period, one BTEX trader exceeded a position accountability level. BTEX's Head of Compliance contacted the member by telephone, and obtained the requisite information.

D. Conclusions and Recommendations

The Division found that BTEX maintains an adequate market surveillance program. NFA is sufficiently staffed and experienced to carry out the Exchange's daily surveillance of market activity. NFA conducts daily monitoring of futures and cash market prices, market news, volume, open interest, and clearing member and large trader positions relating to each Exchange

¹² BTEX Rule 414.

contract. NFA also conducts daily review of position accountability exception reports, and reviews trading information to identify unusual or abnormal price relationships. NFA's automated computer systems, including the large trader reporting function and trader profile function in TAPS, make relevant data and exception reports available to and sortable by NFA analysts. These systems give NFA and BTEX routine access to the positions and trading of market participants. There were no problematic contract liquidations during the target period. The Division has no recommendations in this area.

V. AUDIT TRAIL

A. Trade Data and Recordkeeping

Each order entered into the BTEX Trading System identifies both the member involved and the individual Authorized Trader making the entry. The Exchange assigns to each member a unique identification code known as a Member ID. Exchange rules require each member to assign a separate identification code, known as a Trader ID, to each Authorized Trader employed by the member or any of its affiliates. To log into and use the Trading System, a trader must enter both the appropriate Member ID and his or her own Trader ID.

The Trading System will not accept orders which do not include all of the order information required under Exchange rules. The required information, in addition to the Member ID and Trader ID required for login, includes the following: the delivery month of the contract; the price; the order type; the quantity; the time or period after which the order expires; an account number or identifier; a customer type indicator; and an origin code showing whether the order is for a customer account or for the member's proprietary account. The Trading System automatically records the time and complete details of every order entered into the system, and maintains a record of this information for all orders submitted in what is called the

logbook or Log B file.¹³ This electronically-recorded data gives the Exchange a complete audit trail that includes all of the details of every trade.

The time of each trade recorded by the Trading System is unalterable by either users or BTEX and no order can subsequently be erased from the Log B file. Although the member who entered an order which is resting in the system can cancel it or can change those of its terms which are not matching criteria, the Trading System records the cancellation or change without deleting the original order, and also records the Member ID and Trader ID of the system user making the cancellation or change.¹⁴

Each day's Log B file is transmitted to and retained by NFA. On a trade-day-plus-one basis, NFA electronically compares each trading day's Log B file with that day's cleared trade file transmitted to NFA by BOTCC, to verify that all trade data in both files is identical. If any differences are found, NFA alerts the Exchange. Once the Log B file is verified, it is maintained by NFA in a database containing all BTEX audit trail data. BTEX also retains an electronic copy of the Log B file for each trading day.

B. Electronic Analysis of Trade Data

NFA accesses BTEX audit trail data through TAPS. TAPS uses this data to generate pre-defined market and trade practice surveillance exception reports designed to detect the following potential trading abuses and unusual trading patterns: direct and indirect trading ahead of customers; direct and indirect crossing of orders; prearranged trading; wash trading; money passing; preferential trading; stop order "fishing" or bidding or offering a market for the purpose of hitting stop orders; marking the close; unusual error account activity; anomalous transfer

¹³ The Trading System can distinguish milliseconds, and orders are recorded in their precise sequence of occurrence.

¹⁴ To change order terms which constitute matching criteria, the member must cancel the original order and enter a new order which does not retain the time priority of the original order.

trades, adjustments, or trade cancellations; anomalous block trades or EFPs.¹⁵ TAPS also provides a trader profile for each trader based on the characteristics of all of his or her trades, and alerts NFA staff to deviations from established trading patterns.

NFA staff review all TAPS exception reports on a daily basis. NFA staff can also use TAPS to query all BTEX audit trail data and reconstruct trading as needed.

C. Safe Storage

BTEX retains a copy of each day's Log B file on a computer hard disk at its Jersey City, New Jersey headquarters. On a nightly basis, BTEX also backs up the day's Log B file on computer tape, and sends the tape by courier to a storage facility in New Jersey for permanent retention. This storage facility is more than 30 miles from BTEX's Jersey City offices. BTEX plans to move its back-up trading system to a business continuity and disaster recovery center, which is approximately 30 miles from New York City, by the end of 2003.

NFA maintains each day's Log B file in a computer database on the servers at its Chicago office. Each day, the Log B data is backed up on tape, and shipped to an offsite storage facility in Illinois for permanent retention. NFA has a disaster recovery backup site approximately 30 miles from its headquarters in downtown Chicago, connected by transmission line to BOTCC and BOTCC's disaster recovery facility. If necessary, NFA could receive the BTEX Log B file at the BOTCC facility and conduct BTEX surveillance from that facility.

D. Conclusions and Recommendations

The Division found that BTEX maintains an adequate audit trail and recordkeeping program. BTEX maintains a complete electronic record of all entries into its Trading System

¹⁵ The parameters of the various exception reports are described in detail in the Schedule A, *Scope of Regulatory Services*, incorporated in the contract between BTEX and NFA. As noted earlier, a copy of Schedule A can be found in Appendix 2.

and the details of every trade, allowing the Exchange to efficiently and effectively reconstruct trading. In addition, any changes to orders are automatically timed and identified. BTEX also has adequate procedures in place for safe storage of audit trail data. These procedures now include storage of audit trail data at disaster recovery facilities approximately 30 miles from the principal places of business of both BTEX and NFA. The Division has no recommendations in this area.

VI. TRADE PRACTICE SURVEILLANCE

A. Daily Automated Reports

As noted above, TAPS provides exception reports designed to detect various types of potential trading abuses and other anomalous trading activity for further investigation. NFA staff review all TAPS exception reports on a daily basis. In addition to conducting exception report review, NFA also uses TAPS to conduct customized searches or reviews of BTEX audit trail data. In this regard, NFA staff have the flexibility to tailor queries based on, for example, the time of transaction, order type, quantity or price.

TAPS also maintains trader profiles. The profiles include average time logged on, average number of trading days per month, frequency of trading, average trade size, profit and loss history, frequent counterparties, and percentage of total volume in a given market. TAPS exception reports alert NFA to deviations from a trader's profile, such as those involving unusual profit patterns, significant changes in volume, unusual concentrations of trading activity between the same counterparties, and unusual error account activity.

B. Inquiries and Investigations

1. Initiation and Tracking of Matters

If NFA determines that trading activity noted in an exception report or uncovered in the course of analysis of BTEX audit trail data requires further scrutiny, staff initiate either an inquiry or investigation. Inquiries, which are less formal than investigations, are opened whenever staff identify an anomaly which needs further examination. NFA opens a formal investigation whenever it discovers or receives a referral concerning possible violations of an Exchange rule, or whenever the results of an inquiry indicate a possible violation of an Exchange rule. NFA informs BTEX Compliance by telephone or e-mail whenever it initiates an inquiry or investigation, and provides BTEX with quarterly reports detailing the number and type of inquiries and investigations conducted, the parties involved, and how the matter was resolved.¹⁶

NFA records and tracks all BTEX inquiries and investigations through its computerized Financial Analysis, Audit, and Compliance Tracking System (“FACTS”), which also provides electronic document retention functionality. FACTS gives each inquiry or investigation a separate identification number, and records the name of the initiating staff member. It also classifies all inquiries or investigations as generated by NFA or resulting from a member or anonymous complaint or a Commission referral, and lists all exception reports involved. For each inquiry or investigation, FACTS maintains the date of each significant investigative action taken, including the date the matter was opened or closed and the date of each information request, interview, or other investigative step.¹⁷

¹⁶ A copy of a quarterly report from the target period can be found in Appendix 3.

¹⁷ If an inquiry evolves into an investigation, the inquiry is closed simultaneously with the opening of the investigation, by the same computer process.

Staff document all work completed in an inquiry or investigation by using FACTS to maintain copies of all notes taken by staff, all documents requested or reviewed, and transcripts or summaries of all witness interviews conducted. Documents submitted in electronic form are retained in FACTS as submitted. If documents are submitted in paper rather than electronic form, NFA scans them into FACTS and retains paper copies. NFA takes any needed witness statements by telephone, tape-records the conversation, and prepares a written transcript or summary which is submitted to the witness and the compliance officer of the member firm involved for their signatures verifying the accuracy of the written record. The transcripts or summaries are then maintained in FACTS, and also retained in paper form, along with the tape recording of the interview. The complete record of an inquiry or investigation can be reviewed in or printed out from FACTS whenever desired.

At the conclusion of an inquiry or investigation, NFA staff records in FACTS a brief summary of the case, including the reason the inquiry or investigation was initiated, the facts discovered, the documents reviewed, any statements taken, and the disciplinary history (if any) of the parties involved. The summary also includes the conclusions reached and any recommendations for further action.¹⁸ NFA's Senior Manager for Trade Practice/Market Surveillance then reviews the summary and the investigative file. The Senior Manager can determine to close an inquiry administratively or to expand it into an investigation, and can determine that an investigation should be closed administratively or be referred to BTEX for consideration of charges. If the Senior Manager refers the investigation to BTEX for consideration of charges, BTEX Compliance then determines whether a disciplinary action should be commenced.

¹⁸ A copy of a summary memorandum from the target period can be found in Appendix 4.

During the target period, no matters were referred to BTEX by NFA for possible disciplinary action, and BTEX accordingly did not convene its Adjudication Committee, which hears all BTEX disciplinary proceedings.¹⁹ In addition, BTEX Compliance imposed no summary fines during the target period.

2. Adequacy of Inquiries and Investigations

NFA opened 11 inquiries during the target period, all of which resulted from staff review of TAPS exception reports. Seven inquiries involved instances of potential wash trading, and four involved one instance each of possible violations of rules relating to cross trades, transfer trades, block trades, and EFPs. NFA closed eight of the 11 inquiries during the target period after determining that Exchange rules had not been violated. Two inquiries involving possible wash trading evolved into investigations and one inquiry involving possible wash trading was closed shortly after the target period.²⁰ The latter inquiry resulted in the issuance of a reminder letter.²¹

NFA conducted three investigations during the target period. In addition to the two investigations that resulted from inquiries, one investigation emanated from a Division referral concerning a large block trade between two subsidiaries of the same member firm. One investigation was closed during the target period, and the remaining two were closed shortly thereafter.

¹⁹ The Adjudication Committee is composed of four members of BTEX's 15-member Board of Directors who are appointed to the Committee by the Board. BTEX Bylaw 7.1 provides that Committee members may but need not be Directors. To date, all members have been Directors.

²⁰ Inquiry Nos. 02-MINV-01673 and 02-MINV-01674 evolved into investigations.

²¹ Inquiry 02-MINV-01685 resulted in the issuance of a reminder letter for possible wash trading. When the trader involved encountered software and connectivity problems that prevented him from properly canceling a resting order, he took the other side of his own order, believing this was the only way to remove the resting order from the system under the circumstances. The trader reported the matter to BTEX.

The Division reviewed the 11 inquiries and three investigations for adequacy. In general, inquiries and investigations were thorough, well documented, and completed in a timely manner. Where necessary, NFA expanded the scope of its reviews to include additional trades or time periods, obtained and reviewed pertinent documents, and obtained statements from relevant traders and other witnesses. For example, in one of the two investigations begun as inquiries, NFA expanded the scope of its initial review to cover three months of trading activity, interviewed the member involved (a market maker responsible for maintaining bids and offers in a BTEX contract), and concluded that the member had inadvertently taken the other side of his own order due to his unfamiliarity with BTEX's matching algorithm.

With respect to the block trade referral, the Division requested that the Exchange investigate whether a 3900-lot block trade transacted by a single account controller for the accounts of two subsidiaries of a member firm was executed in conformance with BTEX's block trading rule, Rule 406.²² In particular, the Division requested that the Exchange examine whether the parties to the transaction represented separate beneficial owners. The block trade in question was executed on December 12, 2001, during the Exchange's first month of operation. NFA expanded its investigation to include all six block trades executed during December 2001, after finding that all six had involved the same subject member's subsidiary accounts on both sides of the transactions.

In conducting its investigation, NFA obtained and reviewed order tickets and e-mail confirmations for each trade and month-end statements for each account involved. NFA found that each block trade had been executed at the prevailing bid and offer in the BTEX Trading

²² The requirements of Rule 406 are discussed below at pages 21-22. A copy of the Division's January 23, 2002 referral letter, the Exchange's June 12, 2002 response (including its investigation report), follow up correspondence from the Division dated August 1, 2002 and a subsequent response from the Exchange dated August 15, 2002 can be found in Appendix 5.

System at the time the transactions occurred. In addition, NFA obtained information and documents concerning the ownership and control of each account involved, indicating that although the two subsidiaries shared office space and several traders controlled accounts at both subsidiaries, each subsidiary was a separate legal entity with a separate tax identification number.

The investigation file also contained a telephone statement obtained from the member's Senior Vice President and Compliance Officer, who stated that one subsidiary was recognized by the Federal Reserve Bank of New York as a primary dealer in U.S. Treasury securities, and the other was a market maker in interest rate swaps. He also stated that the purpose of the block trades was to reduce the subsidiaries' market risk by partially hedging their cash market exposure. The file contained a listing of the cash market positions held by each subsidiary account on the date of each block trade. However, NFA did not ask the member to identify the specific cash market positions which corresponded to the hedges underlying the block trades in order to confirm the stated economic purpose of the transactions. In similar future circumstances, such inquiry should be conducted.

3. Timeliness of Inquiries and Investigations

The Division also reviewed all of the inquiries and investigations conducted during the target period for timeliness, and found that all were completed in a timely manner. The eight inquiries closed during the target period, the single inquiry open at the end of the target period but closed after the target period, and the two inquiries expanded into investigations were all closed within 120 days. The investigation closed during the target period was open for 131 days. The two investigations open at the conclusion of the target period were closed shortly after the end of the period, within 120 days of their opening.

C. Conclusions and Recommendations

The Division found that BTEX maintains an adequate trade practice surveillance program. NFA, which conducts BTEX's trade practice surveillance program, uses various exception reports to identify possible trading violations, and monitors trading on a real-time basis. NFA opened 11 inquiries and three investigations during the target period, the majority involving possible wash trades. In one block trade investigation, NFA obtained a listing of related cash market positions, but did not identify the specific cash market positions corresponding to the hedges underlying the block trades in question in order to confirm the stated economic purpose of the transactions. In general, however, inquiries and investigations were thorough, well-documented, and completed in a timely manner. The three investigations were closed with findings of no violations, and one inquiry resulted in the issuance of a reminder letter. The Division has no recommendations in this area.

VII. OFF-EXCHANGE TRANSACTIONS

BTEX rules require that all transactions involving Exchange contracts must be bid, offered, and executed through the Trading System, with the exception of block trades, EFPs, and exchange of futures for swaps transactions ("EFSs").²³

A. Block Trades

BTEX Rule 406 permits block trades in all BTEX products, transacted outside the Trading System, between eligible contract participants ("ECPs") or certain other parties.²⁴ A block trade must have a minimum size of 250 contracts, and must involve a BTEX clearing

²³ No EFSs were transacted at BTEX during the target period.

²⁴ Persons who are not ECPs can be parties to a block trade only if they have total assets exceeding \$25 million under management, and are being advised by either (a) a person registered with the Commission as a CTA, registered with the SEC as an investment adviser, or exempt from such registration, or (b) a foreign person performing a similar role and under similar foreign regulation.

member either as the clearing member for both parties or as a party to the trade.²⁵ A clearing member may not take the opposite side of a block trade with its own customer without the customer's prior consent.²⁶ Block trades can be executed at any time either during or outside a BTEX trading session.²⁷

A clearing member involved in a block trade must maintain full and complete records of the trade, including a record of any customer order that must be timestamped with the time the order is received and the time it is executed.²⁸ The clearing member must satisfy BTEX upon request that the trade complies with BTEX rules.²⁹

BTEX requires that block trades be reported to the Exchange by the clearing member involved, or by the seller if both parties are clearing members, within a specified number of trading session minutes from the time of execution. The reporting deadline lengthens with increased trade size, with the shortest reporting time of 15 trading session minutes after execution for the smallest permissible block trades, and the longest reporting time of 240 trading session minutes after execution for large block trades.³⁰ The block trade details that must be reported include quantity, contract, contract month, price, time and date of execution, buying and/or selling clearing firm number, and buying and selling trader identification.

²⁵ During the target period, Exchange rules restricted block trading to block trades involving a BTEX Market Maker or Market Maker's Affiliate as either the clearing member effecting the trade or a party to the trade. On April 14, 2003, the BTEX Board of Directors approved revisions to both Rule 406 and the Exchange's Market Maker Program that expanded the block trading privilege to all BTEX clearing members.

²⁶ BTEX Rule 406(c).

²⁷ BTEX Rule 406(e).

²⁸ BTEX Rule 406(b), 406 (f), and 406 (g).

²⁹ BTEX Rule 406(g).

³⁰ The time limits for reporting, established in BTEX Rule 406(d), are as follows: 15 trading session minutes for block trades of 250-999 contracts; 30 trading session minutes for 1,000-2,499 contracts; 60 trading session minutes for 2,500-4,999 contracts; 120 trading session minutes for 5,000-9,999 contracts; and 240 trading session minutes for 10,000 or more contracts.

Clearing members report block trades by calling the BTEX Market Support Desk. When a block trade is reported, BTEX Market Support staff record in writing in a block trade blotter the time of the report and the required details of the trade, which include, as noted above, the time at which the trade was made. The Market Support Desk rejects submission of block trades which are not reported within the time limits specified in BTEX rules. Support Desk staff enter the trade details into a browser-based computer application, which has a template to capture the respective data fields cited above and the name of the person who reported the trade. The application automatically records the time the information is entered.³¹ Once all required information is entered, the information appears on BTEX's website and thus is disseminated to traders and the public. The website's block trade window displays all block trades reported during the current trading day in chronological order, listing for each block trade the quantity, contract, contract month, price and time, and date of execution. Complete details of block trades are also transmitted to NFA for surveillance purposes.

NFA has established procedures for routine review of BTEX block trades to determine whether the parties involved were eligible contract participants or otherwise qualified under BTEX rules, and whether the trades were reported to the Exchange in a timely manner and met minimum size requirements. TAPS exception reports identify each block trade that fails to meet minimum block trade size requirements, and each block trade executed at a price outside the trading range on the day of the trade up to the time the trade was reported to BTEX. Another TAPS exception report identifies block trades not reported within the required time limits, by comparing the block trade execution time as reported by the clearing member with the time at

³¹ In most cases, the computer entry is made immediately after the initial recording of the information in the block trade blotter, although computer entry can be delayed in cases where the Help Desk receives another call requiring immediate attention.

which the BTEX Market Support Desk entered trade details into BTEX's block trade information application.

NFA's procedures call for review of both (a) block trades identified in the exception reports describe above, and (b) a sample of other block trades. NFA selects block trades for review if they involve an anomaly or other suspicious characteristics, such as a party not previously involved in block trading, a block of unusual size, or a block trade between customers that have a relationship. If a block trade is identified or selected for review, NFA obtains and reviews relevant documentation concerning the trade and takes statements from the parties involved, if necessary.

During the target period, 237 block trades involving 230,744 contracts (approximately 12% of the total target period volume of 1,979,409 contracts) were executed at BTEX.³² The Exchange conducted only two reviews of member block trading compliance during the target period, covering seven of the 237 block trades. Specifically, in addition to investigating the Division's block trade referral, discussed above, the Exchange opened one block trading inquiry when an exception report indicated that a member may have failed to report a block trade within the time required under BTEX rules.³³ NFA closed the inquiry without further action after determining that the member had in fact reported the trade within the required time, and that the trade had been identified in the exception report due to a data entry error.

B. EFPs

BTEX Rule 407 permits EFPs by means of related and simultaneous cash and futures transactions between two parties where the buyer and seller of the futures are, respectively, the

³² Of the 237 target period block trades, 225 involved subsidiaries of the BTEX member whose subsidiaries were the parties to the trades reviewed in the investigation resulting from the Division's referral, discussed above at pages 18-19.

³³ Inquiry #02-MINV-01093.

seller and buyer of an approximately equivalent quantity of the physical commodity. EFP transactions may be effected in all futures contracts offered for trading at BTEX.³⁴

BTEX members who enter into an EFP report the transaction to the Exchange by submitting it for clearing through BOTCC's Allocate & Claim Transaction System ("ACT").³⁵ Under BTEX rules, the clearing member for the seller of the futures must submit the transaction for clearing.³⁶ When the EFP is submitted through ACT, BOTCC includes it in the daily cleared trade information it transmits to both BTEX and NFA. BTEX includes information on the EFP in its volume and price reports, and NFA includes it in its TAPS system for surveillance purposes. Each party to an EFP must satisfy BTEX upon request that the transaction complies with BTEX rules.³⁷

NFA has established procedures for routine review of BTEX EFP transactions to determine whether they were bona fide and were executed in accordance with Exchange rules. TAPS generates exception reports that identify all EFPs involving either contracts outside the current delivery month or a price outside the contract's trading range at or before the time the EFP was executed. NFA reviews all EFPs identified on the exception reports, and other EFPs which appear anomalous, such as those involving unusual size, unusual transaction patterns, a relationship between the customers, or a customer not previously active in EFPs.

³⁴ BTEX Rule 408 permits EFS transactions. However, as stated earlier, no EFSs have been transacted at BTEX to date.

³⁵ BOTCC uses this system to receive submission for clearing of transactions done outside an exchange's trading system.

³⁶ BTEX Rule 407(h). BTEX rules do not require members to report EFPs directly to the Exchange, although BTEX sometimes receives information on an EFP when one of the traders involved calls the BTEX help desk for assistance concerning the EFP.

³⁷ BTEX Rule 407(i).

Under NFA's review procedures, when an EFP is selected for review staff notify the BTEX Compliance Department that NFA is opening an inquiry, and obtain documents from the firms involved in order to verify the cash side of the transaction.³⁸ Documents requested include corresponding order tickets, copies of futures and cash account statements, trade blotters, and cash contracts evidencing the transference of the cash commodity.³⁹ After reviewing the documents and information obtained, NFA takes statements from individuals involved, in person or by telephone, if deemed necessary. At the conclusion of the inquiry, staff either enter a case conclusion comment into the Notes facility in TAPS or expand the inquiry into an investigation.

During the target period, 35 EFPs involving 7,554 contracts were executed at BTEX. NFA reviewed the bona fides of one EFP involving a total of 39 contracts. The EFP was selected for inquiry because it involved an unusual size of only 39 contracts, and was transacted between different proprietary accounts of the same BTEX member. The Division reviewed the inquiry and found that it was thorough, well-documented, and completed in a timely manner. NFA reviewed daily statements for the accounts involved, trade sheets for both the futures and cash sides of the transaction, as well as relevant order tickets. NFA concluded that the transaction was a bona fide EFP after verifying that a corresponding quantity of the physical commodity was exchanged, and that the futures portion of the trade was a legitimate hedge of the cash portion.

³⁸ EFP documentation is defined in Commission Regulation 1.35(a-2)(4) as "those documents customarily generated in accordance with cash market practices which demonstrate the existence and nature of the underlying cash transaction, including, but not limited to, contracts, confirmation statements, telex printouts, invoices, and warehouse receipts or other documents of title."

³⁹ If delivered electronically, documents are retained in NFA's FACTS 2000 computer system, where all inquiries and investigations are recorded in a database. If delivered in hard copy form, documents may be scanned into FACTS 2000 in electronic form, and are also retained in hard copy form in locked file cabinet storage at NFA's Chicago office.

C. Conclusions and Recommendations

The Division found that BTEX generally maintains an adequate program for surveillance of its off-exchange transactions. NFA uses various exception reports to identify possible trading violations with respect to block trades and EFPs, and also reviews other block trades and EFPs involving anomalous characteristics. The two inquiries and one investigation concerning off-exchange transactions conducted during the target period were thorough and well-documented, included appropriate analyses, and were completed in a timely manner.

However, the Division believes that the Exchange did not examine a sufficient number of block trades or EFPs to ensure that members are complying with Exchange rules. In this regard, Schedule A incorporated in the regulatory services agreement between BTEX and NFA calls for NFA to review selected block trades and randomly selected EFPs to determine whether they were executed pursuant to BTEX rules. During the target period, NFA did not select any block trades or EFPs for review on a random basis. While review of block trades and EFPs identified by exception reports or otherwise presenting anomalies is an important part of the Exchange's surveillance program for off-exchange transactions, adequate enforcement of block trade and EFP rules should include the review of randomly-selected block trades and EFPs. This is true even where a majority of such trades involve the same parties, as was the case with respect to the target period block trades. Without a program of random review, block trades and EFPs that do not appear anomalous, but otherwise may violate Exchange rules, could escape scrutiny.

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

- **Review its block trade and EFP rule enforcement programs and implement modifications necessary to ensure examination of an adequate number of block trades and EFPs for compliance with Exchange rules.**