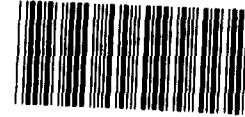


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Strengthening Trade Practice Oversight

Statement of
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Committee on Agriculture, Nutrition and Forestry
United States Senate



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FUTURES MARKETS:
STRENGTHENING TRADE PRACTICE
OVERSIGHT

SUMMARY OF STATEMENT BY
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In response to a request from the Honorable Patrick J. Leahy, Chairman, and Richard G. Lugar, Ranking Minority Member, Committee on Agriculture, Nutrition and Forestry, GAO answered a number of questions on the adequacy of oversight controls, the number and nature of disciplinary actions, the effects of high technology systems, and the use of management information relating to the nation's futures markets.

In summary, GAO is recommending that the Commodity Futures trading Commission (CFTC) do the following:

- 1) Direct the exchanges to independently, precisely, and completely time each trade made on the exchanges and specify a time frame for meeting this requirement. This should significantly reduce the opportunity to commit trading violations and avoid detection.
- 2) Assess the merits and risks of using automated systems through use of its own resources or those of others, including independent contractors. This will help ensure that the exchanges maximize their potential to control trade practice abuses and provide correct transaction processing, responsive operations, and secure and continuous service.
- 3) Require complete documentation of existing and upgraded automated surveillance systems and independent tests of these systems. This should better ensure that the exchanges' surveillance programs operate as intended.
- 4) Establish milestones for completing definitions of trade practice violations and investigations, as well as begin making formal trend and comparative analyses of consistently defined investigations and disciplinary actions. This should help CFTC highlight issues for review; show the relative effectiveness of exchange approaches to detecting, investigating, and punishing abuses; and identify aspects of successful programs that all exchanges could adopt.

GAO issued two reports yesterday that discuss these recommendations--Futures Markets: Strengthening Trade Practice Oversight (GAO/GGD-89-120, Sept. 7, 1989) and Futures Markets: Automation Can Enhance Detection of Trade Abuses But Introduces New Risks (GAO/IMTEC-89-68, Sept. 7, 1989).

Mr. Chairman and Members of the Committee:

We are pleased to appear today to discuss our views on how the Commodity Futures Trading Commission (CFTC) and the exchanges it regulates can better deter, detect, and punish floor trade practice abusers in the futures markets. At your request, we have followed up on our February appearance before this Committee and explored several questions you raised about the adequacy of oversight controls, the number and nature of disciplinary actions taken, the effects of high technology trading systems, and the use of oversight information. Our results are contained in two reports that we issued yesterday.¹ To do the work, we visited the Chicago Board of Trade (CBT), the Chicago Mercantile Exchange (CME), the New York Mercantile Exchange (NYMEX), and the Commodity Exchange Inc. I would like to summarize our results in my testimony.

Recent allegations about the trading activities of certain futures market participants raise important questions about the integrity of these markets and about the quality of federal and self-regulatory oversight. In August 1989, the Department of Justice, as a result of Federal Bureau of Investigation (FBI) undercover operations, indicted 46 floor participants at the CBT and CME for engaging in trade practice abuses. These abuses

¹Futures Markets: Strengthening Trade Practice Oversight (GAO/GGD-89-120, Sept. 7, 1989) and Futures Markets: Automation Can Enhance Detection of Trade Abuses But Introduces New Risks (GAO/IMTEC-89-68, Sept. 7, 1989).

which allegedly involved various schemes to enrich floor participants, violated the Commodity Exchange Act, CFTC regulations, and exchange rules.

INDEPENDENTLY, PRECISELY, AND COMPLETELY TIMING TRADES

Our work also has shown that dishonest floor participants, working alone or with a third party, can eliminate the risk of unfavorable market movements. They can manipulate the information on their trading records to give noncompetitive trades the false appearance of having been competitively executed at an earlier time when prices were more favorable to them. These practices could be deterred or more easily detected through independent, precise, and complete timing of trades.

Independent timing could prevent floor participants from using their knowledge of the market price in the immediate past to alter trading records and conceal execution of trades at noncompetitive prices. Precise timing could be used to determine the exact sequencing of each floor participant's trades, thereby making it easier to detect abuses. Complete timing, including the times the floor participant receives and executes the trade, could help reconstruct the history of each trade, not only to detect potential abuses, but also to prove that they occurred.

Exchange trading systems generally do not independently, precisely, and completely time all trades to sequence trading activity. Instead, exchanges attempt to reconstruct the sequence of trades using times that may be based on inaccurate or incomplete information. The timing information used to reconstruct the sequence of trades is part of the "audit trail," which is the documentation for all trades.

Audit trail information is obtained somewhat differently at each exchange, and different weaknesses exist in the audit trails of each exchange. However, the audit trail systems of three of the four exchanges we visited include some timing information provided by floor participants, such as trade time and sequence information. These systems, therefore, depend on the participants to submit accurate and complete timing information. The fourth exchange's system records times independently. But like the other systems, it does not record times precisely or completely. Therefore, it has difficulty sequencing trades, especially in active markets. In each system, opportunities exist to manipulate the timing and, therefore, the sequencing of trades.

CFTC requires each exchange to prepare a trade register that shows, for each cleared or matched trade, the execution time to the nearest minute. CFTC allowed the exchanges to develop individual audit trail systems to meet this 1-minute timing

standard and required that the exchanges be able to report on the accuracy of the information. Three of the four exchanges report that between 84 and 90 percent of trade times can be verified as meeting the 1-minute timing standard. CFTC officials told us that CBT does not have a system for reporting on the accuracy of its trade times.

To the extent that audit trail information from floor participants is used to meet the 1-minute timing standard and reach the reported verification rates, neither the times nor their verification rates may be reliable. Even if the 1-minute times were reliable, they are not precise enough to always allow for complete sequencing of each floor participant's trades because many trades can occur within a 1-minute period. Finally, none of the exchanges precisely times when floor participants receive or execute customer orders. This time could help establish when the participants assume responsibility for promptly and competitively executing the orders.

CFTC proposed rule amendments in August 1989, tightening controls over the preparation and the submission of trading cards and submission of customer order tickets that will improve timing information and trade sequencing. The rules could go into effect in early 1990, and the exchanges have already begun implementing some of these changes as well as others. While these changes are important interim measures, floor participants will still be

relied on to provide accurate trading records, and trade times will not be exact and complete.

In addition to the steps CFTC and the exchanges are taking to improve their existing system of controls, all four exchanges are exploring applications of new technology and automated systems that could provide more independent, precise, and complete trade timing. CBT and CME are studying and developing automated order routing systems to increase the efficiency of the futures trading process. All four exchanges are developing electronic audit trail systems to record transactions using hand-held terminals. CME, CBT, and NYMEX are also developing trading systems that will replace the current trading process to expand operations outside normal trading hours. These systems are still in the planning or development stage, and the extent that the exchanges will take advantage of the technology to control trading abuses is uncertain.

If properly implemented, these systems may lead to the independent, precise, and complete timing of trades necessary to better deter and detect trading abuses. Because many systems are just beginning to be developed, the time frame for achieving these goals is likely to be more than a year. Thus, CFTC and exchange proposals to tighten controls over trade practice abuses in current systems should be implemented quickly to provide needed interim improvements.

A lot of attention has been directed to the effect of dual trading on market integrity. Dual trading allows floor participants to trade for their personal accounts and those of customers on the same day. Market professionals generally agree that dual trading has several benefits, including increasing market liquidity. However, dual traders have the opportunity to trade ahead of customer orders and profit by making a series of trades and allocating the most favorable ones to their personal accounts and the least favorable ones to customers' accounts. This opportunity raises concerns about the extent to which dual traders are cheating customers and has led to proposals to restrict dual trading.

Restricting dual trading would not prevent floor brokers from using a third party to indirectly trade ahead of customers. In fact, the Justice Department indictments allege that some brokers were using third parties in an attempt to mask illegal trades. Trading ahead abuses could more easily be detected if trade times were independent, precise, and complete because the exact sequence and price of each floor participant's trades could be readily determined, as could the time when the floor broker received the order. Therefore, restricting dual trading is not a substitute for improved timing information in reducing opportunities to commit trading violations.

ASSESSING AUTOMATED SYSTEMS

Although the exchanges' planned automated systems have the potential to better control trading abuses through independent, precise, and complete trade timing, they introduce risks that must be addressed to ensure correct transaction processing, responsive operations, and secure and continuous service. The exchanges are aware of these risks and are taking steps to mitigate them.

However, CFTC has not been actively involved in technical assessments of these systems' capabilities to control trading abuses and automation risks. CFTC needs to provide the necessary expertise to ensure that the systems currently planned by the exchanges maximize their potential to control trade practice abuses. It also needs to assess the risks of using automated systems. To accomplish these goals, CFTC could allocate its own resources, establish a technical advisory committee, and/or require the exchanges to have independent assessments performed on their systems under CFTC guidelines.

IMPROVING AUTOMATED SURVEILLANCE

Trade practice abuses can be detected by various means, such as manual review of the trade register, surveillance of the trading floor, and complaints from members. In addition, at different

times over the last 4 years, the exchanges began using automated trade surveillance systems to review all trading activity and to provide investigators with exception reports that highlight suspicious trading activity. These systems can screen large volumes of trading data for potential abuses more efficiently than can manual methods. However, as we have discussed, the audit trail data upon which these systems rely is too imprecise for screening programs to accurately identify all potential abuses, and some of the systems are still in the early stages of development.

CFTC reviews the parameters and output of screening programs to determine the appropriateness of the leads the programs generate. However, CFTC does not review system documentation or test screening programs to determine whether the surveillance systems are operating as intended. In addition, CFTC does not require that the systems be independently assessed. Exchange officials told us that complete documentation has not always been available to describe initial system design, any subsequent modifications, and test results of those modifications. Such documentation is needed to determine whether the systems are operating as intended. A CFTC or other independent test of screening programs could include running data containing known violations through the exchanges' systems. Our recommendations are designed to improve the oversight of exchanges' automated surveillance systems.

USING MANAGEMENT INFORMATION

CFTC uses investigatory and disciplinary action information to judge specific exchange decisions and to monitor exchange progress from one rule enforcement review to another. It cannot use this information to formally analyze trends and compare results among exchanges because no uniform definitions exist for classifying the investigations and disciplinary actions involving floor trade practice abuses.

Such analyses and comparisons could help CFTC identify patterns in exchange oversight results that might highlight issues for review; show the relative effectiveness of different exchange approaches to detecting, investigating, and punishing abusers; and identify aspects of successful programs that all exchanges could adopt. For example, by tracking and comparing the exchanges' performance, CFTC could determine those detection methods that generate the most leads and could direct other exchanges to incorporate those methods, as appropriate. CFTC and the exchanges are beginning to develop uniform definitions. Our recommendations are designed to ensure their rapid completion and to encourage CFTC to better use the resulting improved disciplinary and investigatory information in its oversight.

ASSESSING DISCIPLINARY
ACTION PROGRAMS

The number and severity of disciplinary actions that the exchanges have taken varies by exchange, but has generally increased as shown in the attached charts. From January 1, 1984, through June 30, 1989, the total number of floor participants penalized at each exchange ranged from a low of 17 at NYMEX to a high of 177 at CME; total fines ranged from about \$300,000 at NYMEX to about \$4.5 million at CME; and total suspensions ranged from about 300 business days at NYMEX to about 14,000 business days at CME.

We were unable to evaluate the significance of the differences in exchange disciplinary actions because the universe of abuses is unknown and the uniqueness and complexity of each case preclude an assessment of the adequacy and consistency of penalties. Moreover, the results of our comparisons of futures and securities market disciplinary actions were not useful because of differences in the types of abuses that occur in the two markets.

CFTC and exchange officials said that they are concerned about perceptions of potential conflicts of interest and about the fairness and consistency of the disciplinary action process. As a result, CFTC has issued proposed rules governing the eligibility of members with prior disciplinary histories to serve

on disciplinary action committees. Also, the exchanges are considering actions, and in some cases have taken actions, that they believe will improve perceptions about the fairness and consistency of disciplinary action programs, including changing the composition of disciplinary committees and establishing minimum penalty guidelines.

SUMMARY AND CONCLUSIONS

In summary, CFTC and exchange officials had been working before the FBI investigations to improve the framework of controls over floor trade practice abuses. They intensified their efforts after news of the investigations became public, and have proposed or taken a series of actions, such as requiring more frequent collection of trading cards, that will improve existing exchange internal controls.

These actions are important interim measures for reducing the opportunity for dishonest floor participants to commit trading violations. However, CFTC and the exchanges must do more. While detecting every abuse may never be possible, CFTC and the exchanges need to take actions that will upgrade the overall character of market oversight and substantially reduce the opportunity to manipulate trading.

Foremost among the actions needed is improved timing of all trades. Most of the types of abuses alleged in the Justice Department indictments could have been more readily detected and documented with independent, precise, and complete timing of trades. For this reason, we are recommending that CFTC require the exchanges to go beyond upgrading existing internal controls and implement systems to independently, precisely, and completely time all trades.

We are also recommending that CFTC enhance its capability to evaluate the risks and technical configuration of emerging automated systems, expand its review of exchange automated surveillance systems, and improve its use of management information. We have not been able to reach conclusions about the adequacy of CFTC or exchange disciplinary action programs, primarily because the universe of abuses is unknown. However, the increased number and severity of penalties for floor trade practice abuses since the FBI investigation became public appears to indicate an increased commitment by the exchanges to deterring, detecting, and punishing trade practice abusers.

I want to make a final point. It has been known for some time that the potential for trading abuses on the futures exchanges is high. CFTC's recent proposals to better control trading abuses are, as I indicated, useful interim measures. But, they do not

go far enough. We believe it essential that CFTC become more proactive in overseeing trading practices.

The alleged abuses in the Department of Justice indictments and the growing importance of the futures markets in our economy make it essential that the operating standards of market participants be upgraded. CFTC needs to lead the effort to accomplish the needed improvements.

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Mr. Chairman, this concludes my prepared statement. We will be pleased to answer questions.

GAO · Futures Floor Trade Practice Disciplinary Actions

<u>The Chicago Board of Trade</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>Total</u>
Floor participants penalized	2	7	14	16	13	12	64
Fines (thousands of dollars)	30	260	156	162	180	1,196	1,984
Suspensions (business days)	819	381	1,012	2,222	6,104	20	10,558
Permanent bar	0	4	2	0	0	2	8
<u>The Chicago Mercantile Exchange</u>							
Floor participants penalized	4	33	27	38	51	24	177
Fines (thousands of dollars)	10	291	190	1,684	558	1,739	4,472
Suspensions (business days)	132	160	58	8,553	3,797	862	13,562
Permanent bar	0	0	0	4	1	2	7

Note: Data cover actions from January 1, 1984, through June 30, 1989.

Source: GAO prepared the table from exchange disciplinary action notices.

GAO. Futures Floor Trade Practice Disciplinary Actions

<u>The New York Mercantile Exchange</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>Total</u>
Floor participants penalized	6	1	5	0	2	3	17
Fines (thousands of dollars)	134	0	128	0	13	48	323
Suspensions (business days)	0	0	199	0	0	105	304
Permanent bar	1	1	0	0	0	0	2
<u>The Commodity Exchange, Inc.</u>							
Floor participants penalized	5	9	22	27	27	13	103
Fines (thousands of dollars)	248	388	421	649	613	375	2,694
Suspensions (business days)	0	147	232	707	411	242	1,739
Permanent bar	0	1	0	0	0	0	1

Note: Data cover actions from January 1, 1984, through June 30, 1989.

Source: GAO prepared the table from exchange disciplinary action notices.