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onExchange - Procedural Flow

Relationships and the Application Process

Market Participant Activities	Exchange / Clearing Activities
Safflower Inc. decides to trade safflower and olive oil futures on onExchange. Its CEO, John Doe, applies to onExchange to become a Subscriber. Jane Buck, Safflower's head oil trader, is appointed by Safflower as its onExchange Authorized Trader.	OnExchange receives Safflower's application, which includes its designation of Jane Buck as an Authorized Trader. The names of Safflower, John Doe, and Jane Buck are forwarded to the NFA for a background check as per the onExchange-NFA agreement. NFA also verifies that Safflower is an Eligible Swap Participant based on Safflower's financial statements and databases (e.g., Dun & Bradstreet). With NFA's check and Safflower's Subscriber Agreement complete, onExchange creates a Trading Account for Safflower. An administrative user ID and password are provided to John Doe. Administrative accounts do not have trading privileges. A trading account user ID and password are provided to Jane Buck. Although Safflower, Inc. has a trading account at onExchange, Jane may not enter trades because the company does not have a Subcustody Account with an onExchange Custody Bank.
Safflower reviews the list of onExchange Custody Banks. Safflower has a pre-existing relationship with Brown Brothers Harriman (BBH), an onExchange Custody Bank. BBH is a Federally regulated commercial bank. John selects BBH and indicates his preference to use BBH to onExchange. OnExchange and BBH have previously entered into a custody agreement, under which BBH maintains an onExchange custody	OnExchange internally assigns the Account at BBH to the Safflower Trading Account and provides Safflower with wire instructions for sending assets to the Subcustody Account.

account and subcustody accounts for the benefit of Subscribers. BBH opens an onExchange subcustody account for the benefit of Safflower.	
John uses his secure internet connection to onExchange to authorize Jane Buck to enter trades for the Trading Account.	Although an onExchange Trading Account has been created and Jane has been authorized to trade, onExchange's trading system prohibits Jane from entering trades because the Account has no assets to cover Original Margin, which is a pre-requisite for positions at onExchange.
As an internal control, John decides to restrict Safflower's trading activity to the safflower and olive oil markets. Furthermore, John decides that Jane should be constrained to trading 20 or fewer contracts per day and a position limit of 20 contracts. John uses his secure internet connection to onExchange to establish these controls.	The onExchange system enforces the controls John has placed on Jane.

Funding Accounts

John deposits six Treasury bills of $10,000 each in the Subcustody Account. He deposits an additional $5,000 in cash.	onExchange awaits BBH's confirmation that the assets were deposited.
BBH notifies onExchange by fax that the 6 T-Bills and cash have been placed in the Account. This includes a description of each asset e.g. face value, CUSIP number, expiration date, issue date, denomination.	OnExchange records these deposits using a clearing administrative screen for asset deposits. OnExchange's records always reflect the assets in the account as verified by BBH in its Custody Bank capacity. The system will now approve Jane's orders subject to the constraints placed by John's administrative limits and original margin availability. Trading may now take place.

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John has arranged also for an irrevocable Letter of Credit (LC) to be provided by B2B Bank (B2BB) for Safflower's positions at onExchange in the amount of $50,000. The LC provides that it can be used only to support margin requirements for Safflower's trading in Safflower or Olive Oil contracts. John notifies onExchange of the LC. John stipulates that he would like the LC to be associated with the same onExchange Trading Account that Safflower previously funded at BBH so that the total amount of Margin Eligible Assets in that trading account is $115,000 ($60,000 T-bills, $5,000 cash, $50,000 LC).	OnExchange awaits the LC from B2BB. Upon receipt of the LC from B2BB, onExchange adds the LC amount, less an LC haircut, to the Trading Account "assets" of Safflower.

Placing Orders and Trading

Jane places a bid to buy 2 lots of Safflower Oil futures for a delivery date of September 29, 2000. She is willing to pay up to $0.55 per gallon. (Contract specifications are appended.)	This limit buy order appears on the onExchange order book and is visible by all market participants. The order displays price and quantity. No other market participants know that this order is from Safflower.
Another marker participant (already enabled to trade) places an offer to sell 2 lots of Safflower Oil futures for delivery on September 29, 2000. His asking price is $0.60 per gallon.	This is also a limit order, but on the sell side of the market. All market participants see that the market for Safflower Oil is bid $0.55 and offered at $0.60.
Jane decides to increase her offer to $0.57. She does this by changing her original offer.	OnExchange treats price changes as a Cancel/Replace so Jane's order now reflects the time priority of a new order. Because no one else has a limit order in the system at the same price or better, Jane is still the best bid. If there were other $0.57 bids entered before Jane's change, Jane would be behind them in the time priority queue. The market is changed to reflect the new information, bid at 0.57 and offered at 0.60.

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At this point the seller decides to hit the $0.57 bid. He can enter the trade in a number of ways: he can cancel and replace his original order with a new one that is either a market order or a limit order at $0.57. Safflower oil futures have an Original Margin of $1,500. Therefore 2 lots will create an Original Margin requirement of 2 times $1,500, or $3,000.	The system notes that a trade match at $0.57 is possible. A real-time credit check is now performed, that Safflower's total Original Margin requirement INCLUDING the result of the new trade is less than the Margin Obligation Eligible Assets identified in the trading account. A parallel credit check occurs for the other market participant. Looking at the funds on deposit for Safflower's Trading Account, the system notes total T-Bill value of $60,000, a $50,000 LC and cash of $5,000. Since T-Bills have a haircut of 5%, and LCs have a 20% haircut, we have a total "operating value" of assets equal to $57,000 ($60,000 minus 5%), plus $40,000 ($50,000 minus 20%) plus $5,000 for a total of $102,000. Clearly, this is greater than the Original Margin requirement, and the Safflower's order is eligible to be matched.
The other market participant does NOT have sufficient Margin Obligation Eligible Assets present at its Custody Bank to support this trade.	Since real-time credit check shows that sufficient funds do not exist at one of the accounts, then no trade can occur between these two parties. The party with the insufficient assets has the order placed on system hold and is notified electronically of the order status and reason. Trade compliance staff is also notified of the situation.
Another market participant with sufficient Margin Eligible Assets hits Jane's bid.	Both parties receive an electronic trade confirmation. Upon match, market data is updated to reflect the match. The last trade price is updated and current volume count is increased. The match is for the more specific product and information regarding that product is updated.

Posting Positions & Account Balances

| John sees the following Trading Account statement: | The system collects and/or computes the following information for display. |

John sees the following Trading Account statement:

Funds:	Face	Available for Margin
Cash	5,000.00	5,000.00
Governments	60,000.00	57,000.00
LC	50,000.00	40,000.00

Margin Requirement
Safflower Oil 2 long @ $1,500.00   ($3,000.00)
Less Open Contract Gains $20.00
Net Original Margin Requirement   ($2,980.00)

Margin Availability $99,020.00

The system collects and/or computes the following information for display.

1) Margin Eligible Assets (Cash, Government Securities, Letters of Credit, Foreign Currencies)

2) Any reduction in the Margin Eligible Assets due to haircuts on Government Securities, Letters of Credit, or Foreign Currency amounts.

2) Margin requirements (Original, Delivery)

3) Gains or losses associated with Open positions reflecting any differences between the last mark-to-market and last pay collect.

4) Gains or losses from Closed Contract positions.

For mark-to-market the reference price is determined by the Exchange and may be the last trade price, a computation derived with bids or offers, or external reference prices.

NOTE: An open contract gain of $20.00 indicates that a mark-to-market occurred since the last pay/collect cycle and that the mark-to-market was in Safflower's favor. Had the pay/ collect occurred, then Safflower's cash would show a balance of $5,020.00 and the Open Contract Gains would show a balance of $0.

As per onExchange Clearing Corporation rule 5.06(b), Open Contract Gains may be applied to Margin Availability, but may not be withdrawn from an account.

Intraday Settlement

For Safflower's account, the reference price is now $0.55, which creates a loss of 0.02 per contract, or a total loss of $20.00. Safflower's Trading Account will be posted with an Open Contract loss of $20.00. Indeed, all accounts will be credited or debited with the amount of the gain or loss.	At midday, the Exchange performs a scheduled intraday mark-to-market using reference prices for all futures contracts. No pay-collect is scheduled as a routine part of this mark-to-market, but all account values are updated. The system performs three different operations during this process. Funds on deposit are revalued (e.g. to reflect changes in the value of Government securities); positions are revalued using the latest reference prices; and the latest Margin levels are applied (e.g. there is an intraday change in margin rates).

End of Day Settlement – Safflower's Trading Account

Safflower Oil Settlement Price is $0.50

Loss is 0.05 * 500 gallons * 2 lots = $50.00

John sees the following Trading Account statement:

Funds:	Face	Available for Margin
Cash	4,9500.00	4,950.00
Governments	60,000.00	57,000.00
LC	50,000.00	40,000.00
Margin Requirement		
Safflower Oil 2 long @$1,500.00	($3,000.00)	
Less Open Contract Gains	$0.00	
Net Original Margin Requirement	($3,000.00)	
Margin Availability	$98,950.00	

The Safflower Oil futures market contract specification calls for daily variation margin payment. Therefore, onExchange Clearing Corporation will debit Safflower's Subcustody account by $50.

In the event that Safflower did not have sufficient assets in the account, the Exchange would notify John of a payment requirement to be met no later than the next morning. Failure to do so would trigger the default proceedings described elsewhere.

NOTE: onExchange has no maintenance level margin amounts for its customers. All variation margin calls must be met regardless of amount.

| John sees the following Trading Account statement: | In the event that the Safflower Oil futures contract did not specify daily variation margin payment, John's account would be marked-to-market as in the intraday example. His Open Contract position would show a loss of $50.00, making his total margin requirement $3,050.00 and his cash amount would remain $5,000. In either case, Margin availability is the same at $98,950.00. |

John sees the following Trading Account statement:

Funds:	Face	Available for Margin
Cash	5,0000.00	5,000.00
Governments	60,000.00	57,000.00
LC	50,000.00	40,000.00

Margin Requirement
Safflower Oil 2 long @$1,500.00	($3,000.00)
Less Open Contract Loss	$50.00
Net Original Margin Requirement	($3,050.00)

| Margin Availability | $98,950.00 |

In the event that the Safflower Oil futures contract did not specify daily variation margin payment, John's account would be marked-to-market as in the intraday example. His Open Contract position would show a loss of $50.00, making his total margin requirement $3,050.00 and his cash amount would remain $5,000. In either case, Margin availability is the same at $98,950.00.

Notwithstanding that variation margin may not be required on a daily cycle, under rule 5.08 the company reserves the right to make a variation margin call (i.e. perform a pay collect) on any contract market at any time. Furthermore, the company reserves the right to make a variation margin call to any Class B member at any time.

Default Scenarios (as contemplated in ONXCC rule 7.01)

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Safflower, Inc. is found in violation of any Exchange rules that threaten the Exchange, its markets, or participants. In this case Safflower would be deemed a Subscriber NOT in good standing of the Exchange and would be subject to the Default Provisions of the Clearing Corp. Rules.	Under the Clearing Corp. Rules Safflower would automatically and without further action be suspended as a Class B Member and would subject Safflower to the Clearing Corp.'s rule 7.02 for Liquidation and Close Out. However, depending on the specific nature of the violation, the suspension may be temporarily postponed by the President if he determines that such suspension would not be in the best interests of the Company. Given the right of appeal at the Exchange for these violations, it is reasonable to assume that the majority of cases would result in a postponement of suspension and no liquidation of contracts. If the suspension is postponed, then the President shall immediately call a special meeting of the Board as soon as practicable, at which the Board may reinstate such suspension or take such other action as may be provided for in the Bylaws or the Rules.
Safflower fails to meet any of its obligations under its Contracts with the Company; or Safflower has a Monetary Default (as in the example above with Safflower's initial counterparty)	This is the most serious type of default. A subscriber's contracts will be liquidated unless 1) there are excess assets sufficient in one or more subscriber accounts to cover the amount due, or 2) liquidation of one or more positions will satisfy the subscriber's obligations. In the later two cases, the subscriber will remain in default and will be restricted to trade for liquidation only until a reapplication for subscriber status is submitted and approved.

Safflower commences a voluntary or a joint case in bankruptcy or files a voluntary petition or an answer seeking liquidation, reorganization, arrangement, readjustment of its debts or any other relief for the benefit of creditors under any bankruptcy or insolvency act or law of any jurisdiction, now or hereafter existing, or Safflower applies for or consents to the appointment of a custodian, liquidator, conservator, receiver or trustee (or other similar official) for all or a substantial part of its property; or Safflower makes an assignment for the benefit of creditors; or Safflower becomes or admits that it is insolvent; or an involuntary case is commenced against Safflower in bankruptcy or an involuntary petition is filed seeking liquidation, reorganization, arrangement, readjustment of its debts or any relief for the benefit of creditors under any bankruptcy or insolvency act or law of any jurisdiction, now or hereafter existing; or if a custodian, liquidator, receiver or trustee (or other similar official) of Safflower is appointed for all or a substantial part of its property; or if the Securities Investor Protection Corporation files an application for a protective decree with respect to Safflower;	Under these conditions Safflower has defaulted and will be permitted to trade for liquidation only. Notwithstanding this limitation, the clearinghouse may liquidate Safflower depending on the circumstances that caused these events. Safflower may reapply to be a Subscriber at a later date.

if Safflower holds a short futures contract position and does not tender a delivery notice on or before the time specified by the Rules of the Exchange on the last day on which such notices are permitted to be tendered, or fails to make delivery by the time specified in the Rules of the Exchange; or if Safflower holds a long futures contract position and does not accept delivery or does not make full payment when due as specified in the Rules of the Exchange	The clearinghouse will be in contact with Safflower to determine the reason for the delivery default. Depending on the nature of the delivery default, the exchange and/or clearinghouse may liquidate the position or use the initial and/or delivery margin to mitigate the situation. In no circumstance does the clearinghouse guarantee that the actual goods specified in the contract are delivered to the long.
if B2BB, who is an onExchange AFI and provides the LC to Safflower fails to timely perform with respect to any demand of payment by the Company for assets that are in the custody account.	B2BB has defaulted and the exchange and clearinghouse will revoke its status as an approved financial institution or custody bank. Furthermore, onExchange will seek to recover amounts from B2BB subject to its agreement with the clearinghouse. Similarly, Safflower has defaulted, but the specific remedy will depend on the circumstances of Safflower. In any event, Safflower, as the onExchange Subscriber, is liable for all amounts due to exchange and clearinghouse.

Operational Aspect of Default Scenario for onExchange Five Year Note Contracts

A trader has $6,000 in his subcustody account and wishes to get short one Five Year Note Contract. The scenario below shows how the onExchange clearinghouse would handle his default.	The onExchange Default mechanism is designed to eliminate risk to the clearing system by linking daily price limits to real-time collection of initial margin, which is a function of the daily price limits.
Five Year Note Contract has Daily Price Limit equal to 20 basis points or $2,000 per contract.	All onExchange Contracts will have Daily Price Limits.

Initial Margin for Five Year Note Contracts is set at $6,000. The trader's subcustody account has exactly $6,000 so the clearinghouse approves the trade.	All onExchange Contracts will have an Initial Margin not less than three times the Daily Price Limit, which equals the maximum loss that could be incurred in two consecutive trading sessions.
The prior settlement for Five Year Notes was 92.00. Today's trading range is 91.80 to 92.20 (20 basis points). The sample trader sold a contract at 91.80 (limit down) and the market settled at 92.20 (limit up).	The maximum loss a trader could experience on the first trading day equals twice the daily price limit (e.g. a sale at 91.80 with a close at 92.20 or a purchase at 92.20 and a close at 91.80).
The sample trader is issued a margin call at the end of the first trading session equal to the $4,000 loss incurred.	All onExchange contracts are marked-to-market daily. The exchange requires that the trader has $10,000 ($4,000 loss plus $6,000 initial margin) in his subcustody account by 9 a.m. the next day.
The sample trader fails to supplement his subcustody account with the $4,000 and is therefore in default.	The exchange notifies the trader that his account is in default and is being liquidated.
The Exchange enters a market order to buy the trader's short position back, but the market is lock limit up at 92.40 and no offer is available.	As per Clearinghouse rule 7.02, the exchange does everything possible to liquidate the contract in a manner that is consistent with mitigating the trader's losses.
At the end of the second trading session, the exchange could not liquidate the contract in the open market or find a suitable hedge to protect itself. As a result, the clearinghouse is forced to assign the contract to the opposite side (i.e. long) on a last-in-first-out basis at a price of 92.40.	Clearinghouse rule 7.02(d)(iv) effects mutualization of risk among market participants in this manner. This is a last resort situation. The clearinghouse will attempt all other means of liquidating the contract as specified in rule 7.02 before resorting to this assignment.
The clearinghouse having assigned the position at 92.40 experiences a loss of $6,000 on this trade. Offsetting this loss is the $6,000 in initial margin coverage that the clearinghouse has in the custody account of the sample trader.	The clearinghouse has successfully transferred both the position and liquidated the loss without experiencing a loss. In all default situations where the clearinghouse acts in this manner, it is certain to protect and maintain its financial integrity.

Appendix (Pro-forma contract and specifications. For example purposes only.)

Contract	Specification Category	Specification
onExchange Safflower Oil Futures		
	Trading unit	30,000 lbs.
	Container	Railway tank car, 50-gallon drums, 10-gallon cans
	Price quotation	Cents/lb
	Daily price limit	1 cent per pound above or below previous day's settlement price.
	Minimum price fluctuation	1/100th cent ($0.0001)/lb
	Expiration cycle	Monthly
	Last trading day	Eighth last business day of the contract month.
	Last delivery day	Last business day of the month
	Delivery locations	New York, Newark, Los Angeles, Des Moines, Houston, Chicago
	Trading hours	From 6:30 p.m. preceding day to 5:30 p.m.
	Daily settlement time	3:00 p.m.