

DCM Designation Form

June 10, 2002

To: The Commission

From: The Division of Trading and Markets
The Division of Economic Analysis
The Office of the General Counsel

Subject: Application of OneChicago, LLC Futures Exchange (OneChicago or Exchange) for Designation as a Contract Market pursuant to Sections 5 and 6(a) of the Commodity Exchange Act (Act).

Consulting: The Division of Enforcement

Recommendation: Staff recommends that the Commission designate OneChicago as a contract market, and simultaneously approve OneChicago’s proposed rules.

Processing Information:

		Responsible Staff	
Official Receipt Date:	1/11/02	Riva Spear Adriance	418-5494
Fast-track Clock Restarted:	3/15/02, 3/29/02 & 4/12/02		

I. Background of the Applicant.

By submissions dated December 21, 2001, through June 10, 2002, the OneChicago, LLC Futures Exchange, (“OneChicago” or “Exchange”), a Delaware limited liability company whose members (“Owners”) consist of the Chicago Mercantile Exchange (“CME”), Chicago Board Options Exchange (“CBOE”) and Board of Trade of the City of Chicago, Inc. (“CBOT”), applied to the Commodity Futures Trading Commission (“Commission” or “CFTC”) for designation as a contract market for the automated trading of futures contracts. CBOE and CME each control a 45 percent interest in OneChicago. CBOT controls the remaining 10 percent interest. The Exchange anticipates that it would offer trading of futures contracts on some or all of the following products: (i) single securities and (ii) narrow-based securities indices.

OneChicago has selected the CBOE match engine, known as *CBOEdirect*, as the platform for the electronic trading facility. Access to *CBOEdirect* would be through either the CBOE Network or the GLOBEX Network for trading and other front-end access; persons that are already connected to either *CBOEdirect* or GLOBEX would be able to connect to *CBOEdirect* for purposes of trading Security Futures using those connections.

OneChicago has contracted with: (1) The Options Clearing Corporation (“OCC”) and CME, both derivatives clearing organizations, to carry out clearing and settlement services for all security futures transactions under agreement with OneChicago; (2) CME, a designated contract market, to perform several of the Exchange’s self-regulatory duties, including conducting trade practice, financial and market surveillance, and investigations, for the Exchange, subject to the decision-making authority of the Exchange; (3) National Futures Association (“NFA”), a registered futures association, to provide dispute resolution services; and (4) the CBOE, a national securities exchange, for use of a modified version of *CBOEdirect* electronic trading system that will accept, disseminate, and match OneChicago orders; all subject to the decision-making authority of the Exchange.

The Commission has not previously approved OneChicago as a contract market in any commodity futures or option contract. Accordingly, the Exchange has submitted to the Commission a proposed trade-matching algorithm, procedures and rules pertaining to OneChicago governance, disciplinary and arbitration procedures, trading standards, recordkeeping requirements, and various other materials to meet the requirements for a board of trade seeking initial designation as a contract market. In furtherance of its SRO responsibilities for contracts traded on the OneChicago trading system, the Exchange also has submitted proposed rules that would establish OCC and CME as the entities for clearing contracts, CME for compliance and surveillance, and NFA for dispute resolution services. OneChicago has

provided the Commission with clear and sufficient information describing the services that CME, CBOE, NFA and OCC have committed to provide to it.

As set forth in Section II and III of this memorandum, the OneChicago application demonstrates compliance with the Act's Section 5(b) Designation Criteria, Section 5(d) Core Principles, and Section 5c(b) Common Provisions regarding designation of contract markets. Accordingly, staff recommends that the Commission designate OneChicago as a contract market and simultaneously approve the following OneChicago Rules and Policies and Procedures:

OneChicago Rules: 101-155, 201-206, 301-309, 401-420, 501-514, 601-615, 701-717, 801-802, 901-902, 1001-1002, and 1101-1102; and Policies and Procedures I-VI.

II. Analysis of OneChicago’s Outsourcing Agreements with CME, CBOE, OCC and NFA, and Proposed Rules for Compliance with the Act’s Designation Criteria for Contract Markets

CONTRACT MARKET CRITERIA FOR DESIGNATION	OneChicago PROPOSAL	COMMENTS
<p>Sec. 5(a) Applications – “A board of trade applying to the Commission for designation as a contract market shall submit an application to the Commission that includes any relevant materials and records the Commission may require consistent with this Act.”</p>	<p>Combined Submissions dated December 21, 2001, through June 7, 2002</p>	<p>Acceptable</p>
<p>Sec. 5(b) CRITERIA FOR DESIGNATION</p>		
<p>Designation Criterion 1 <i>In General</i> – “To be designated as a contract market, the board of trade shall demonstrate to the Commission that the board of trade meets the criteria specified in this subsection.”</p>		<p>Acceptable</p> <p><i>See Attachments</i></p>
<p>Designation Criterion 2 <i>Prevention of Market Manipulation</i> – “The board of trade shall have the capacity to prevent market manipulation through market surveillance, compliance, and enforcement practices and procedures, including methods for conducting real-time monitoring of trading and comprehensive and accurate trade reconstructions.”</p>	<p>OneChicago Rule 603 prohibits market manipulation; The Application at 1; Appendix B-1 (Regulatory Services Provided to OneChicago by CME Division of Market Regulation, dated April 19, 2002); Appendix B-3 (Regulatory Services Agreement, execution copy, dated April 2, 2002) Schedule A; and Appendix B-4 (Regulatory Services Systems representation by CME to OneChicago, dated May 16, 2002).</p>	<p>Acceptable.</p> <p>OneChicago has contracted with CME to conduct all of its market surveillance (both real-time and post-trade). CME has established procedures designed to reveal the commission of various trading abuses (including attempts to manipulate futures prices), monitoring positions of large traders, deliverable supplies and futures and cash prices.</p> <p>OneChicago represents that the CME would have access, on a daily basis, to the equity audit trail file from the Securities Industry Automation Corporation (“SIAC”), but the agreement between OneChicago and SIAC has not been executed. SIAC would consolidate large trader information from CME member firms, CBOE firms, and Board of Trade Clearing Corporation (“BOTCC”) member firms, and provide it to the CFTC and CME (as well as other SROs). This data, in</p>

		<p>conjunction with data that would be provided directly to the CME, will be used to populate the CME’s large trader database. As OneChicago is in the process of contracting with SIAC, the Commission should condition its designation upon the provision of an executed agreement between SIAC and OneChicago. <i>See infra</i> Discussion IV.D.</p>
<p>Designation Criterion 3 Fair and Equitable Trading – “The board of trade shall establish and enforce trading rules to ensure fair and equitable trading through the facilities of the contract market, and [sic] the capacity to detect, investigate, and discipline any person that violates the rules. The rules may authorize – (A) transfer trades or office trades; (B) an exchange of futures – (i) futures in connection with a cash commodity transaction; (ii) futures for cash commodities; or (iii) futures for swaps; or (C) a futures commission merchant, acting as principle or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if the contract is reported, recorded or cleared in accordance with the rules of the contract market or a derivatives clearing organization”</p>	<p>OneChicago Appendix A-1 (Rulebook) Rules 406 through 411 (Execution of Orders, Order Processing, Crossing Trades, and Market Data/Execution Acknowledgments), 416 (EFP), 417 (Block Trades), 418 (Error Trades), 514 (Market Maker Programs), 601 (Fraudulent Acts), 602 (Fictitious Transactions), 610 (Priority of Customers’ Orders), 611(Trading Against Customers’ Orders), 612 (Withholding Orders), 613 (Disclosing Orders), 614 (Pre-Arranged Trades), 615 (Simultaneous Buying and Selling Orders) and 702 (Oversight of Regulatory Affairs).</p> <p>Appendix A-2 (Policies and Procedures), Appendix B-1 (Regulatory Services Provided to OneChicago by CME), Appendix B-3 (Regulatory Services Agreement between OneChicago and CME), Appendix C-1 (CBOE<i>direct</i> Functional Requirements), Appendix C-2 (Matching Services Agreement), and Application, at 1-2.</p>	<p>Acceptable.</p> <p>OneChicago has contracted with CME to conduct its trade practice surveillance and investigate possible trading abuses. Regulatory services performed by the CME would be under the supervision of and subject to the direction of OneChicago’s General Counsel. CME has established procedures for detection and investigation of trading abuses. OneChicago and CME have represented that the trade practice and market surveillance conducted for it by CME would be comparable to or consistent with the description of such surveillance set forth in Appendices B-1 and with the demonstration of those services provided to Commission staff on May 1, 2002.</p> <p>Information regarding all transacted prices would be provided to users with real-time access to data. A “snapshot” summary of market depth would be provided to all users on a real-time basis upon request, with the first five levels of the book depth dynamically updated. Members, their employees and “Access Persons” (market participants that have been guaranteed by a OneChicago Clearing Member) would have access to the trading system.</p> <p>The Commission should remind the Exchange that the following are considered rules and should be submitted as such to the Commission pursuant to 5c(c) of the Act: (1) minimum contract sizes and time reporting requirements for block trades; (2) the no bust range for error trades; and (3) adjustments to the trade allocation method, including changes to LMM programs. <i>See infra</i> Discussion IV(A) (Lead Market Maker Program).</p>

<p>Designation Criterion 4 Trade Execution Facility – “The board of trade shall (A) establish and enforce rules defining, or specifications detailing, the manner of operation of the trade execution facility maintained by the board of trade, including rules or specifications describing the operation of any electronic matching platform; and (B) demonstrate that the trade execution facility operates in accordance with the rules or specifications.”</p>	<p>OneChicago Appendix A-1 (Rulebook) Rules 403–13 (Entry and Execution of Orders), Rule 514 (Market Maker Programs) Appendix A-2 (Policies and Procedures), Appendix C-1 (CBOE<i>direct</i> Functional Requirements), Appendix C-2 (Matching Services Agreement, and Application at 2.</p> <p>OneChicago’s Contract Market Application; OneChicago’s response to CFTC’s Technical Review questionnaire; CBOE API Volume 7: CBOE<i>direct</i> Certification and Testing Procedures; CBOE FIX Protocol Support Volume 6: FIX 4.2 Certification and Testing Guide; Architecture View Visio Diagram; CBOE<i>direct</i> Deployment Version 2.0.0 Visio Diagram; Merc-CBOE Interfaces Version 1.1.5 Visio Diagram; Change Password Procedures; Screen Based Trading Application Architecture; CBOE Audit Reports with updated Management Responses for CFTC of 1/16/02; SBT Version 1.0 Test Specification; System Capacity and Performance; SBT Failover Mechanism and Tests; Systems Support Organization Chart; Help Desk Organization Chart; Help Desk User Guide Version 1.1</p>	<p>Acceptable.</p> <p>OneChicago has selected the CBOE match engine, known as CBOE<i>direct</i>, as the platform for the electronic trading facility. A Matching Services Agreement between OneChicago and CBOE has been executed for an initial term of three years.</p> <p>OneChicago would configure the matching algorithm by product. Orders would be executed in accordance with a Combined Price-Time and Size (pro rata) Priority trade allocation method, under which orders at identical prices are filled in proportion to their size sequentially by entry time. Currently, two priorities would overlay the pro-rata allocation for all products: a Lead Market Maker (“LMM”) Participation Trade Right and a “Market Improver” right. The Market Improver right would be subordinate to the LMM Participation Right. <i>See infra</i> Discussion IV (Lead Market Maker Program and Trading Algorithm).</p> <p>As stated under Designation Criterion 3, <i>supra</i>, the Commission should remind the Exchange that adjustments to the trade allocation method, including changes to Lead Market Maker programs are considered rules and should be submitted as such to the Commission pursuant to 5c(c) of the Act.</p> <p>Functional demonstration and mock trading of permitted order types conducted on May 1, 2002 for Commission staff verified that the system operates in accordance with the rules and specifications provided.</p> <p>OneChicago has provided extensive documentation regarding the development, operation, and maintenance of their electronic trade execution facility. That documentation includes system architecture diagrams and descriptions, security features and procedures, system development life cycle procedures and management, testing procedures, capacity planning practices, failover recovery plans, and help desk procedures. OneChicago also provided a series of</p>
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		<p>audit reports performed by CBOE’s Internal Audit and reviewed by Deloitte & Touche LLP. These documents also include updated management responses for the CFTC.</p> <p>During a site visit to the CBOE operations and system development areas on April 23, 2002, system and its supporting infrastructure, the testing of the system, the staff and operational control facilities supporting the operation, and the physical security and environmental controls provided by the CBOE facilities.</p> <p>All technical and operational information obtained by staff supports a conclusion that OneChicago’s proposed electronic trading system would comply with the IOSCO principles for screen-based trading.</p>
<p>Designation Criterion 5 <i>Financial Integrity of Transactions</i> – “The board of trade shall establish and enforce rules and procedures for ensuring the financial integrity of transactions entered into by or through the facilities of the contract market, including the clearance and settlement of the transactions with a derivatives clearing organization.”</p>	<p>OneChicago Appendix A-1 (Rulebook) Rules: 302 (Clearing Members), 303 (Exchange Members), 304 (Access Persons), 501 (Books and Records), 502 (Inspection and Delivery), 503-506 (Financial Requirements), 507 (Customer Protection, Registration); One Chicago Appendix D-2 (Clearing and Settlement Service Agreement between OCC and OneChicago); One Chicago Appendix D-3 (Associate Clearinghouse Agreement between OCC and CME); and One Chicago Appendix D-4 (Clearing and Settlement Service Agreement between CME and OneChicago).</p>	<p>Acceptable.</p> <p>OneChicago has entered into clearing agreements with two DCOs, OCC and CME. OneChicago clearing members must be clearing members of either OCC or CME.</p> <p>OneChicago Rule 503 provides that each Clearing Member, Exchange Member, and Access Person that is registered with the Commission as an FCM or IB must comply with the minimum financial requirements for FCMs and IBs set forth in Commission Rule 1.17, while those that are registered with the SEC are required to comply with the minimum financial requirements for BDs set forth in SEC Rule 15c3-1. Both Rule 1.17 and Rule 15c3-1 provide that a dually-registered FCM/BD must maintain minimum adjusted net capital at a level that is equal to or greater than the Commission’s minimum adjusted net capital requirement or the SEC’s minimum adjusted net capital requirement. OneChicago Rule 506 provides that OneChicago may impose capital requirements on clearing members that would exceed CFTC or SEC minimums.</p>

<p>Designation Criterion 6 <i>Disciplinary Procedures</i> – “The board of trade shall establish and enforce disciplinary procedures that authorize the board of trade to discipline, suspend, or expel members or market participants that violate the rules of the board of trade, or similar methods for performing the same functions, including delegation of the functions to third parties.”</p>	<p>OneChicago Appendix A-1 (Rulebook) Rules, Chapter 7 (Enforcement of Rules and Related Matters), Rule 306 (Limitations of Access Privileges), Rule 307 (Application of Rules and Jurisdiction), Appendix B-1 (Regulatory Services Provided to OneChicago by CME), Appendix B-3 (Regulatory Services Agreement between OneChicago and CME) and Application at 3.</p>	<p>Acceptable.</p> <p>OneChicago disciplinary procedures are consistent with Commission regulations and interpretive guidance regarding core principles.</p> <p>OneChicago has contracted with CME to investigate possible rule violations and present written investigation reports to the OneChicago Probable Cause Committee and OneChicago Business Conduct Committee. Any Probable Cause Committee panel meeting to determine whether a reasonable basis exists to issue charges to commence a disciplinary proceeding would include five individuals representing clearing members or Exchange members, a chairperson and two voting non-members. Any panel of the Business Conduct Committee that will hear the charges would include five individuals representing clearing members or Exchange members, a chairperson and two voting non-members. CME would fill the prosecutorial function in these proceedings. OneChicago retains responsibility for disciplinary procedures, with oversight duties assigned to the General Counsel.</p>
<p>Designation Criterion 7 <i>Public Access</i> – “The board of trade shall provide the public with access to the rules, regulations, and contract specifications of the board of trade.”</p>	<p>OneChicago Application, at 3 – 4 (Public Access) and Appendix A-1 (Rulebook) Rule 309.</p>	<p>Acceptable.</p> <p>OneChicago represents that it would post all rules and contract specifications on its website, and disseminate changes to rules and contract specifications by mail, courier service, fax, or email, to each clearing member and Exchange member, as well as publish such notices on the OneChicago website.</p>
<p>Designation Criterion 8 <i>Ability to Obtain Information</i> – “The board of trade shall establish and enforce rules that will allow the board of trade to obtain any necessary information to perform any of the functions described in this subsection, including the capacity to carry out such international information-sharing agreements as the Commission may require.”</p>	<p>OneChicago Appendix A-1 (Rulebook) Rule 206 (Regulatory Cooperation), Rule 501 (Books and Records), Rule 502 (Inspection and Delivery), Rule 702 (Oversight of Regulatory Affairs), Appendix B-1 (Description of Market Surveillance, Compliance and Enforcement Practices and Procedures), and Application, at 4.</p>	<p>Acceptable.</p> <p>Clearing members, Exchange members and Access Persons would be required to make their books and records available for inspection by, and deliver copies thereof as requested by, OneChicago. The General Counsel and the Division of Market Regulation have the authority to inspect and request books and records</p>

		<p>and to request testimony regarding any possible violation of the Rules of the Exchange.</p> <p>OneChicago represents that it would join the Intermarket Surveillance Group (“ISG”) and Intermarket Financial Surveillance Group (“IFSG”) and become a party to other relevant information-sharing agreements to assure that it has access to market surveillance data and other information relevant to its self-regulatory programs. OneChicago further represents that the CME would have access to the equity audit trail file from the SIAC on a daily basis, but the agreement between OneChicago and SIAC has not been executed. As OneChicago is in the process of contracting with SIAC, the Commission should condition its designation upon the provision of an executed agreement between SIAC and OneChicago. <i>See infra</i> Discussion IV.D.</p>
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III. Analysis of OneChicago’s Outsourcing Agreements with CME, CBOE, OCC and NFA, and Proposed Rules for Compliance with the Act’s Designation Criteria for Contract Market.

CONTRACT MARKET CORE PRINCIPLES	OneChicago PROPOSAL	COMMENTS
<p>Sec. 5c(b) Common Provisions Applicable to Registered Entities (1) In General – “A contract market or derivatives transaction execution facility may comply with any applicable core principle through delegation of any relevant function to a registered futures association or another registered entity.” (2) Responsibility – “A contract market or derivatives transaction execution facility that delegates a function under paragraph (1) shall remain responsible for carrying out the function.”</p>		<p>Acceptable</p> <p>OneChicago would remain responsible for compliance with designation criterion and core principles for which relevant functions have been contracted out.</p>
<p>SEC. 5c(e) NEW CONTRACTS, NEW RULES, AND RULE AMENDMENTS – (1) In General – Subject to paragraph (2), a registered entity may elect to list for trading or accept for clearing any new contract or other instrument, or may elect to approve and implement any new rule or rule amendment, by providing to the Commission (and the Secretary of the Treasury, in case of a contract for sale of a government security for future delivery (or an option on such a contract) or a rule or rule amendment specifically related to such a contract) a written certification that the new contract or instrument or clearing of the new contract or instrument, new rule, or rule amendment complies with this Act (including regulations under this Act). (2) Prior Approval – (A) In General – A registered entity may request that the Commission grant prior approval to any new contract or other instrument, new rule, or rule amendment.</p>		<p>Acceptable</p> <p>OneChicago has requested that the Commission approve its proposed rules (including the proposed Rulebook and Policies and Procedures), in connection with its designation as a contract market. The Divisions recommend such approval pursuant to Section 5c(c)(2)(A) of the Act, since the Policies and Procedures and Rulebook does not violate any provision of the Act or the Commission’s regulations. As the Divisions have determined, and the Exchange has agreed, that the Exchange should adopt rules to cover certain governance issues, but the Exchange will not have finished the adoption of such rules prior to designation, the Commission should include condition its designation upon adoption of such rules. <i>See infra</i> Discussion IV.E.</p>

<p>Core Principle 1 <i>In General</i> – “To maintain the designation of a board of trade as a contract market, the board of trade shall comply with the core principles specified in this subsection. The board of trade shall have reasonable discretion in establishing the manner in which it complies with the core principles.”</p>		<p>Acceptable</p>
<p>Core Principle 2 <i>Compliance with Rules</i> – “The board of trade shall monitor and enforce compliance with the rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.”</p>	<p>OneChicago Appendix A-1 (Rulebook) Rules 701 – 717 (Enforcement of Rules and Related Matters), Appendix B-1 (Regulatory Services Provided to OneChicago by CME), Appendix B-3 (Regulatory Services Agreement between OneChicago and CME), Appendix C-1 (CBOE<i>direct</i> Functional Requirements) and Application, at 4.</p>	<p>Acceptable. OneChicago has contracted with CME to conduct its trade practice surveillance and investigate possible trading abuses.</p> <p>CME has established procedures for detection and investigation of trading abuses. <i>See supra</i> discussion under Designation Criterion 3. OneChicago and CME have established appropriate procedures to promote the fairness of investigations and ensure appropriate, thorough, and timely investigative analysis. CME would have sufficient staff and electronic resources for conducting investigations and has established procedures for regular report and document review to detect possible trading abuses.</p> <p>OneChicago would maintain a full electronic audit trail record of all trades, orders, quotes and other entries to the trading system. Details of all entries into the trading system, including date and time of such entries and the user ID of the user making the entry, are captured and loaded into an order history database. The order history database is stored for seven years. OneChicago regulatory systems, including the CME, can retrieve information from the order history database as needed throughout the seven-year period.</p>
<p>Core Principle 3 <i>Contracts Not Readily Subject to Manipulation</i> – “The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation.”</p>	<p>OneChicago Application at 4.</p>	<p>Acceptable. OneChicago did not submit a futures or option contract with its contract market application. OneChicago intends to submit contract terms and conditions after it has been approved as a contract market. In its Application, OneChicago states that all contracts would comply with the listing standards of Commission Regulations 41.21 and 41.25.</p>

<p>Core Principle 4 <i>Monitoring of Trading</i> – “The board of trade shall monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.”</p>	<p>OneChicago Application at 4); Appendix B-1 (Regulatory Services Provided to OneChicago by CME Division of Market Regulation, dated April 19, 2002); Appendix B-3 (Regulatory Services Agreement, execution copy, dated April 2, 2002) Schedule A; and Appendix B-4 (Regulatory Services Systems representation by CME to OneChicago, dated May 16, 2002).</p>	<p>Acceptable. OneChicago has contracted with the CME to conduct its market surveillance.</p> <p>Appendix B-1 (p.2) states that the CME has developed and implemented a comprehensive program for daily surveillance in order to deter abuse, detect problems and initiate corrective actions in its markets. The surveillance procedures outlined in Appendix B-1 and Schedule A of the Regulatory Services Agreement should minimize the potential for manipulation, distortion of prices, or disruption of delivery.</p> <p>As mentioned in Designation Criterion 8 <i>supra</i>, OneChicago represents that the CME would have access to the equity audit trail file from the SIAC on a daily basis. However, the agreement between OneChicago and SIAC has not been executed. SIAC would consolidate large trader information from CME member firms, CBOE firms, and BOTCC member firms, and provide it to the CFTC and CME. This data, in conjunction with data that would be provided directly to the CME, would be used to populate the CME’s large trader database. As OneChicago is in the process of contracting with SIAC, the Commission should condition its designation upon the provision of an executed agreement between SIAC and OneChicago. <i>See infra</i> Discussion IV.D.</p>
<p>Core Principle 5 <i>Position Limitations or Accountability</i> – “To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary and appropriate.”</p>	<p>Appendix A-1 (Rulebook) Rule 414; Appendix B-1 (Regulatory Services Provided to OneChicago by CME Division of Market Regulation, dated April 19, 2002); and Appendix B-3 (Regulatory Services Agreement, execution copy, dated April 2, 2002) Schedule A.</p>	<p>Position limits or Accountability limits would be established in the rules and contract specifications of OneChicago futures and options contracts. Those contracts are not included in the OneChicago application to be a contract market. The OneChicago application acknowledges CFTC Regulation 41.25 regarding the setting of position limits, exemptions from speculative position limits for bona fide hedging positions and inter-commodity spread positions, and aggregation of positions and Appendix B of Part 38.</p> <p>The Commission should remind the Exchange that Position Limits or Position Accountability procedures must be specified for futures contracts listed by the</p>

		Exchange. All Position Limits or Position Accountability procedures should be included with the Exchange's filing to the Commission in connection with the listing of a futures contract submitted under the Commission's certification or approval procedures.
<p>Core Principle 6 <i>Emergency Authority</i> – “The board of trade shall adopt rules to provide for the exercise of emergency authority, in consultation or cooperation with the Commission, where necessary and appropriate, including the authority to – “(A) liquidate or transfer open positions in any contract; (B) suspend or curtail trading in any contract; and (C) require market participants in any contract to meet special margin requirements.”</p>	<p>OneChicago Application at 5; Appendix A-1 (Rulebook) Rules 205, 419, 707</p>	<p>Acceptable</p> <p>The Chief Executive (or a designee approved by the Board or the Business Conduct Committee) could place into immediate effect temporary rules. Among other actions, the Chief Executive could order the liquidation of contracts, the fixing of the settlement price or liquidation-only trading, suspend or limit trading, extend/shorten the expiration date or month, extend the time of delivery or change delivery points and/or the means of delivery, modify trading hours, impose position or price limits, or modify or suspend the rules of the Exchange of the Clearing Corporation.</p> <p>Under Rule 205(b), no member of the Board or Business Conduct Committee could vote if such member knowingly had an interest in the matter. The member could participate in deliberations if, after the Board was informed of the conflict, disinterested Board members so decided upon consideration of the public interest.</p> <p>The Chief Executive Officer (or his designee approved by the Board) could also take various actions in response to physical emergencies, which would include any circumstance that could have a severe or adverse effect upon physical functions.</p>
<p>Core Principle 7 <i>Availability of General Information</i> – “The board of trade shall make available to market authorities, market participants, and the public information concerning – (A) the terms and conditions of the contracts of the contract market; and (B) the mechanisms for executing transactions on or through the facilities of the</p>	<p>OneChicago Application at .3; Appendix A-1 (Rulebook) Rules 309, 403-405, 501-506.</p>	<p>Acceptable.</p> <p>OneChicago would publish its rules, regulations and contract specifications on its website.</p>

contract market.”		
<p>Core Principle 8 <i>Daily Publication of Trading Information</i> – “The board of trade shall make public daily information on settlement prices, volume, open interest, and opening and closing ranges for actively traded contracts on the contract market.”</p>	<p>OneChicago Application at 5.</p>	<p>Acceptable.</p> <p>Daily information on settlement prices, volume and open interest would be made public through its website and market data vendors.</p>
<p>Core Principle 9 <i>Execution of Transactions</i> – “The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions.”</p>	<p>Appendix A-1 (Rulebook), Rule 417 (Block Trading) Rules 403 – 410 (Entry and Execution of Orders), Appendix A-2 (Policies and Procedures), OneChicago’s Contract Market Application; OneChicago’s response to CFTC’s Technical Review questionnaire; CBOE API Volume 7: CBOEdirect Certification and Testing Procedures; CBOE FIX Protocol Support Volume 6: FIX 4.2 Certification and Testing Guide; Architecture View Visio Diagram; CBOEdirect Deployment Version 2.0.0 Visio Diagram; Merc-CBOE Interfaces Version 1.1.5 Visio Diagram; Change Password Procedures; Screen Based Trading Application Architecture; CBOE Audit Reports with updated Management Responses for CFTC of 1/16/02; SBT Version 1.0 Test Specification; System Capacity and Performance; SBT Failover Mechanism and Tests; Systems Support Organization Chart; Help Desk Organization Chart; Help Desk User Guide Version 1.1</p>	<p>Acceptable.</p> <p><i>See supra</i> Designation Criterion 4, and <i>infra</i> Discussion IV (Lead Market Maker Program), for additional discussion.</p> <p>Block trade minimum size and reporting time would be set on a product-specific basis, and accordingly, would be submitted in a Specifications Supplement for each Contract when OneChicago submits such contracts.</p> <p>OneChicago has provided sufficient documentation and other information for Commission staff to conclude that the OneChicago system would comply with the IOSCO principles for screen-based trading systems.</p> <p>The CBOE<i>direct</i> system is currently in use for screen-based options trading so it is of proven production quality. Sufficient tests have been run demonstrating required capacity for security futures can be met. Also, because of the modular system architecture design, adding additional capacity should be relatively easy.</p> <p>The applicant’s system development process shows a high level of maturity as evidenced by their use of sound systems and software engineering practices such as requirements documentation, system design modeling, written test plans, automated testing, automated support for configuration management, and multiple levels of quality assurance reviews.</p> <p>Periodic independent audits of the system have been</p>

		<p>and would continue to be conducted. Previous recommendations for improvements have been acted upon.</p> <p>The data center is of production quality and the operations staff is experienced managing equipment supporting high volume trading. Essentially all of the key application & data servers have redundant back-up equipment in stand by mode.</p> <p>Building security is tight with the use of a metal detector, multiple guards, and mandatory checking of personal belongings prior to entry. Access to the data center, development labs, etc. is via access cards. Various system security measures are in place including encryption, digital signatures, passwords, and intrusion detection software. CBOE<i>direct</i> is on a private network on which the remote workstations have a digital certificate and are reauthorized every 2 minutes.</p>
<p>Core Principle 10 Trade Information – “The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables the contract market to use the information for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market.”</p>	<p>OneChicago Appendix A-1 (Rulebook) Rule 403 (Order Entry), 406 (Bunched Orders), Appendix A-2 (Policies and Procedures), Appendix C-1 (CBOE<i>direct</i> Functional Requirements), and Application at 6.</p>	<p>Acceptable.</p> <p>OneChicago has contracted with CME to conduct its trade practice surveillance and investigate possible trading abuses. CME has established procedures for detection and investigation of trading abuses. <i>See</i> additional discussion under Designation Criterion 3, above.</p> <p>Orders submitted to OneChicago must specify commodity, contract month, buy or sell, order type, price, quantity, account type/CTI/Origin Code, account designation, executing firm, broker acronym, exchange identifier (CBOE, CME, or CBOT – used to ensure uniqueness among clearing firm numbers and acronyms), time in force. The Account Type/Origin Code supported by the CBOE<i>direct</i> platform is the equivalent of the CTI code. A market maker’s acronym would be the default account number for the corresponding market maker. For non-market maker orders, a customer account number is required. The</p>

		<p>system cannot accept orders that are not valid.</p> <p>Prior to entering any order, the relevant employee or Access Person must sign onto the OneChicago system by inputting the user identification assigned for such purpose by the Exchange. The user identification, consisting of a user acronym and an Exchange identifier, would be carried from the point of order or quote entry through the submission of executed trades to clearing and would be available as part of the audit trail. OneChicago Rules make Clearing Members and Exchange Members responsible for every order entered by them, their employees or their authorized Access Persons.</p> <p>All orders not entered into the trading system immediately upon receipt by a Clearing Member, Exchange Member or Access Person must be recorded in non-alterable written medium on an order form that is timestamped with the receipt of the order.</p> <p>The trading system would automatically capture all details of each trade in a comprehensive electronic audit trail. Every action in respect to an order or quote would be timestamped to a millisecond. A complete record of all order and quote activities would be provided to the OneChicago order history database. The order history tables would be updated each time an order is changed, with the date and time of such change, as well as the user ID of the user making the change. Order history would be retained and retrievable for seven years. OneChicago would also maintain a history of all quote requests for a period of seven years. All activity within the trading system would be recorded in the data warehouse in a manner that protects the data from unauthorized alteration, as well as from accidental erasure or other loss.</p> <p>The OneChicago data warehouse would also store additional historical data for a period of seven years, including OneChicago Main Session data, Trade History, Large Trade Data (from SIAC), ILX Data</p>
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		<p>(ILX is a market data vendor), OCC Data (compliance tape), and Membership Data (clearing table).</p> <p>CME's computer surveillance systems would enable CME to reconstruct OneChicago's cleared market transactions on a T+1 basis and to sort all transaction history data as desired.</p>
<p>Core Principle 11 <i>Financial Integrity of Contracts</i> – “The board of trade shall establish and enforce rules providing for the financial integrity of any contracts traded on the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization), and rules to ensure the financial integrity of any futures commission merchants and introducing brokers and the protection of customer funds.</p>	<p>OneChicago Appendix A-1 (Rulebook) Rules: 302 (Clearing Members), 303 (Exchange Members), 304 (Access Persons), 501 (Books and Records), 502 (Inspection and Delivery), 503-506 (Financial Requirements), 507 (Customer Protection, Registration); One Chicago Appendix D-2 (Clearing and Settlement Service Agreement between OCC and OneChicago); One Chicago Appendix D-3 (Associate Clearinghouse Agreement between OCC and CME); and One Chicago Appendix D-4 (Clearing and Settlement Service Agreement between CME and OneChicago).</p>	<p>Acceptable</p> <p>OneChicago has entered into clearing agreements with two DCOs, OCC and the CME. All transactions executed on OneChicago must be entered into or guaranteed by a OneChicago clearing member (and all clearing members are members of either the OCC or CME).</p> <p>OneChicago Rules: 302, 303, 304, and 507 provide that an entity soliciting or accepting an order from any other person must be registered with the Commission or with the SEC in a capacity that permits it to solicit or accept orders from other persons. Therefore, any entity transacting customer orders on OneChicago must be registered as an FCM with the Commission or as a broker or dealer (“BD”) with the SEC.</p> <p>In addition to the Commission’s minimum capital requirements, CME Rule 970.D. (and notices issued to members) requires each clearing member to maintain minimum capital of \$2,000,000. OCC Rule 301 requires clearing members to have at least \$1,000,000 of initial minimum capital and to maintain \$750,000 of minimum capital on an ongoing basis.</p> <p>As all clearing members would be members of the CBOE and/or CME, they would be subject to the financial surveillance programs that are currently in place for FCMs and BDs. Each clearing member would be assigned to one DSRO and/or DEA that would be primarily responsible for performing financial surveillance of the firm. <i>See infra</i> Discussion IV.B on the proposed financial surveillance program.</p>

<p>Core Principle 12 Protection of Market Participants – “The board of trade shall establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants.”</p>	<p>OneChicago Appendix A-1 (Rulebook) Rules 403 (Order Entry), 409 (Crossing Trades), 416 (EFPs), 417 (Block Trades), 508 (Confirmations), 512 (Responsibility for Customer Orders), 601 – 615 (Business Conduct), Appendix A-2 (Policies and Procedures), Appendix B-1 (Description of Market Surveillance, Compliance and Enforcement Practices and Procedures), Appendix B-3 (Regulatory Services Agreement between OneChicago and CME) and Application, at 6.</p>	<p>Acceptable.</p> <p>OneChicago has contracted with CME to conduct its trade practice surveillance and investigate possible trading abuses.</p> <p>CME has established systems and procedures for detection and investigation of trading abuses. <i>See</i> additional discussion under Designation Criterion 3, above. CME would use these systems to monitor for, among other things: inter-market frontrunning, intra-market frontrunning, insider trading, trading ahead of customer orders, marking the close, noncompetitive trading, wash sales and position limit violations, as well as, ex-pit trade reviews, position transfer and adjustment reviews, profit/loss reviews, profiles and percentages analysis.</p> <p>Members are required to use due diligence and meet appropriate standards in the handling and execution of customer orders and reporting order executions to customers. Except as may be permitted by rule, members are prohibited from executing wash trades, cross trades, or pre-arranged trades. Members may not manipulate or attempt to manipulate the price of, or attempt to corner, any commodity.</p>
<p>Core Principle 13 Dispute Resolution – “The board of trade shall establish and enforce rules regarding [sic] and provide facilities for alternative dispute resolution as appropriate for market participants and any market intermediaries.”</p>	<p>OneChicago Rule 801(a), Rule 802 and OneChicago Appendix E-2 (Letter Agreement between OneChicago and NFA)</p>	<p>Acceptable.</p> <p>OneChicago has contracted with NFA for arbitration services, to be carried out under NFA’s Code of Arbitration. Use of NFA’s dispute resolution facility would be voluntary for customers that do not qualify as an eligible contract participant unless such customer gave prior written consent in accordance with Commission regulation 166.5(c).</p>
<p>Core Principle 14 Governance Fitness Standards – “The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the</p>	<p>OneChicago Rule 129 (Exchange Member), Rule 203 (Eligibility), Appendix F (Governance Fitness Information for Members of the Board of Directors), and OneChicago Application at 6.</p>	<p>Acceptable.</p> <p>OneChicago limits who can serve on the Board, certain committees and associated panels, generally following</p>

<p>contract market, and any other persons with direct access to the facility (including any parties affiliated with any of the persons described in this paragraph).”</p>		<p>the standards set out in Commission regulation 1.63. As OneChicago members would already be members of CME, CBOT or of CBOE, such members would be subject to the fitness standards of those exchanges. OneChicago’s General Counsel has provided affidavits certifying the fitness of governing members.</p>
<p>Core Principle 15 <i>Conflicts of Interest</i> – “The board of trade shall establish and enforce rules to minimize conflicts of interest in the decision-making process of the contract market and establish a process for resolving such conflicts of interest.”</p>	<p>OneChicago Rules 204 (Confidentiality), 205 (Conflicts of Interest), 419 (Emergencies) 703 (Business Conduct Committee), and 704 (Probable Cause Committee); and OneChicago Application at 6.</p>	<p>Acceptable.</p> <p>OneChicago prohibits any Board member or member of the Business Conduct Committee, Probable Cause Committee or any “disciplinary committee” or oversight panel from knowingly participating in the deliberation or vote on a matter if the member is the named-party in interest, has a specified relationship with a named-party in interest, or has a substantial financial interest in the matter. OneChicago requires those members to disclose any such conflicts of interests. A member may participate in the deliberation of a matter in which the member has a substantial financial interest if the members decided that such participation was consistent with the public interest, and necessary for a quorum or the member possesses unique expertise.</p> <p>OneChicago Rule 204 does not permit Board members or committee members to use or disclose material, non-public information obtained as a result of their fulfillment of their duties except for the performance of their official duties. Officers, employees or agents of the Exchange may not trade in any commodity interest if they have access to “material non-public information concerning such commodity interest,” and must not disclose such information if they could reasonable expect such information may assist another to trade.</p>
<p>Core Principle 16 <i>Composition of Boards of Mutually Owned Contract Markets</i> – “In the case of a mutually owned contract market, the board of trade shall ensure that the composition of the governing board reflects market participants.”</p>		<p>Not-Applicable. OneChicago would not be a mutually-owned exchange as membership would not represent an ownership interest in the Exchange. Instead, the Exchange is owned by CME, CBOT and CBOE.</p>

<p>Core Principle 17 Recordkeeping – “The board of trade shall maintain records of all activities related to the business of the contract market in a form and manner acceptable to the Commission for a period of 5 years.”</p>	<p>OneChicago Appendix A-1 (Rulebook) Rules 403 (Order Entry), Rule 502 (Inspection and Delivery), Appendix C-1 (CBOEdirect Functional Requirements) and Application, at 7.</p>	<p>Acceptable. OneChicago has contracted with CME to conduct its trade practice surveillance and investigate possible trading abuses.</p> <p>OneChicago has represented that it would comply with Commission Regulation 1.31 and that a duplicate set of data would be kept off-site by both the CBOEdirect system and the CME, as well as a duplicate set of data to be maintained on the CME mainframe.</p> <p>OneChicago trading system would automatically capture details of each trade in a comprehensive electronic audit trail record of all trades, orders, quotes and other entries to the trading system. Details of all entries into the trading system, including date and time of such entries, the user ID of the user making the entry, and the time of execution to the nearest millisecond are captured and loaded into an unalterable order history database. The order history database is stored for seven years. OneChicago regulatory systems, including the CME, can retrieve information from the order history database as needed throughout the seven-year period.</p>
<p>Core Principle 18 Antitrust Considerations – “Unless necessary or appropriate to achieve the purposes of this Act, the board of trade shall endeavor to avoid – “(A) adopting any rules or taking any actions that result in any unreasonable restraints of trade; or (B) imposing any material anticompetitive burden on trading on the contract market.”</p>	<p>One Chicago Appendix D-2 (Clearing and Settlement Service Agreement between OCC and OneChicago, Section 14); One Chicago Appendix D-3 (Associate Clearinghouse Agreement between OCC and CME, Section 8(e)); and One Chicago Appendix D-4 (Clearing and Settlement Service Agreement between CME and OneChicago); OneChicago Responses dated March 28, 2002 and May 7, 2002; and Application at 7.</p>	<p>Acceptable. But <i>see infra</i> Discussion IV.B and C for discussion of competition issues. The Commission should remind the Exchange that the Commission is not approving service agreements for compliance with Core Principle 18.</p>

IV. Novel or Unusual Issues

a. *The OneChicago Lead Market Maker Program and Trading Algorithm*

According to OneChicago, the Exchange has decided to use a market maker trading model to promote liquidity in its contracts.¹ The OneChicago Rules and Policies and Procedures allow a number of members to act as market makers (*e.g.*, as locals) for each security futures product traded on the Exchange, although the Exchange would select only one market maker as the lead market maker (“LMM”) for each security futures product.² Each LMM would be obligated to provide continuous, two-sided markets for all expiration months in each of the contracts allocated to it.³ In consideration of its commitment to offer a two-sided quote on all contracts allocated to it and to respond to requests for quotes at all times during trading hours, each LMM would have an LMM Trade Participation Right that granted the right to participate in all trades of the LMM’s designated contracts that are executed at the LMM’s quoted bid or offer price.

The CBOEdirect trade-matching engine supports two basic trade allocation methodologies: price-time and combined price-time pro-rata. On top of these allocation methods, several optional priorities can be overlaid based on a variety of orders.⁴ While OneChicago could vary the allocation method contract by contract, OneChicago has stated that it initially plans to apply the same algorithm with the same allocation/overlay combination to all products.⁵

At the outset, OneChicago would use the Combined Price-Time and Size Priority matching allocation (“pro-rata allocation”). Under pro-rata allocation, resting orders are prioritized according to price and time. When two or more orders are at the best price, trades are allocated in a pro rata fashion in proportion to the size.⁶ Remaining orders are sequentially allocated fills on a pro rata basis.⁷

¹ See OneChicago Policies and Procedures Section VI (Lead Market Makers and Trade Allocation Methods (Rule 514) at 11; Appendix A-1 (Rulebook) Rules 514 and 406; and Appendix J (Lead Market Makers and Trade Allocation Methods).

² OneChicago has selected an initial group of 24 member firms to serve as LMMs. The Exchange anticipates allocating its first set of futures on single stocks and narrow-based stock indices to be listed on the launch date to 17 of the 24 firms selected as LMMs, and the remaining firms would be eligible to receive allocations to serve as LMMs for the next wave of futures to be introduced by the Exchange.

³ LMMs would enter two-sided quotes for their designated contracts using a quote function on the OneChicago System. To fulfill its quote obligation to the Exchange, the LMM’s quote must be no wider than the width and for an amount equal to or greater than the size prescribed by the Exchange’s LMM committee.

⁴ The optional priority overlays include: lead market maker (“LMM”), market improver, and customer orders. The Exchange has chosen not to utilize the customer order priority overlay. In addition to an ability to choose the base allocation method and overlays/priorities, the sequence of application of the optional priorities may be specified. (Appendix A-1 (Rulebook) Rule 406).

⁵ See OneChicago Policy and Procedures Section VI (Lead Market Makers and Trade Allocation Methods (Rule 514) and OneChicago Responses dated May 7, 2002 at 6.

⁶ The executable quantity under Combined Price-Time and Size Priority would be allocated to the nearest whole number, with fractions of ½ or greater rounded up and fractions of less than ½ rounded down. If two market

However, the Exchange has chosen two priorities that would overlay the pro-rata allocation, the LMM Trade Participation Right and Market Improver priority overlays, with the Market Improver priority being subordinate to the LMM Trade Participation Right. As the pro-rata allocation is subject to the two priority overlays, trades are not allocated under the pro-rata allocation until after fills allocated under applicable priority overlays have been completed. First, under the LMM Trade Participation Right priority overlay, each LMM is granted an initial allocation of 30 percent of each trade executed when an LMM's order and/or market-making quote joins an existing order and/or quote at the best price, provided the LMM may not be allocated a total quantity of contracts (1) that would represent a greater percentage than such LMM's percentage of the total size at the best price before the trade participation right was applied; or (2) greater than the quantity for which the LMM has placed orders or has quoted.⁸

Following application of the LMM's Trade Participation Right, the Market Improver has an allocation priority to be filled for its entire bid/offer quantity if possible. The Market Improver is a market participant who was the first market participant to enter an order or quote at a better price than the previous best price. Only after the LMM and the Market Improver have received fill allocated under the Trade Participation Right and the Market Improver priority overlays, would any contracts remaining to be filled on an order be allocated pro rata to resting orders based on their order entry time.

OneChicago's usage of a pro-rata allocation and a Market Improver priority is similar to algorithms used by other futures exchange automatic trading systems approved by the Commission. OneChicago's utilization of the LMM Trade Participation Right priority overlay, however, differs somewhat from algorithms previously considered by the Commission. OneChicago views the LMM Trade Participation Right as improving liquidity in the market and states that the trade participation right priority initially granted to LMMs for a particular contract could be "turned off" if the liquidity in the relevant market no longer required or warranted such incentives.⁹ As OneChicago's algorithm is included in its Policies and Procedures, market participants would have notification of the Exchange's chosen allocation method.

participants are both entitled to an additional 1/2 contract but only one contract remains to be allocated, the remaining contract would be distributed based on time or quote priority.

⁷ The computer would actually allocate the pro-rata fills sequentially starting with the order with the earliest entry time and recalculate the total pro-rata pool after each fill, rather than calculating all the pro-rata percentages at one time following the LMM and the Market Improver fills. The only effect of this sequential method of allocation would be in cases where two market participants were both entitled to an additional 1/2 contract but only one contract remains to be distributed. As stated in note 6, *supra*, the remaining contract would be distributed based on time or quote priority.

⁸ See Rule 406(b)(iii)(B). Further, when both the trade participation right priority and the market improver priority were in effect and the LMM was the market improver for the relevant price, the market improver priority would not be applicable. Finally, in determining the parties to a particular trade, a LMM's Trade Participation Right would be applied against such LMM's bids and offers in accordance with their relative priority.

⁹ OneChicago Responses dated March 28, 2002, at 8; CBOE *direct* Trade Allocation Themes Algorithm Examples provided to the Commission on May 28, 2002, at 1.

The following examples are provided to illustrate OneChicago's chosen pro-rata allocation with the LMM Trade Participation Right ("TPR") overlay and the subordinate Market Improver ("MI") overlay. In each example, all resting bids, including the LMM's, are for the same price and are listed in order of time priority. Notes below describing the application of the TPR overlay, the MI overlay and the pro-rata allocation are in chronological order of application.

EXAMPLE 1: Incoming market order to sell 100 contracts at a specific price

Book Resting Bids:

Category	Bid Qty	1 st Fill from TPR (30%)	2 nd Fill from MI	Quantity remaining after match with incoming order	Notes
MI	100		70	30	2
Order 2	200			200	
Order 3	200			200	
LMM	100	30		70	1
Total	600	30	70	500	

Notes:

1. Pool of all orders = 600. LMM Pool % = $(100/600) = 17\%$, which is less than the basic 30% TPR share. Therefore, the TPR 30% share would be used, allocating the LMM 30 contracts (30% x 100 contracts on sell order), leaving 70 contracts from the incoming offer remaining to be filled (and also leaving the LMM with an un-filled bid quantity of 70 contracts).
2. The MI gets filled on the remaining 70 contracts, leaving no further offer quantity to be allocated pro rata.

EXAMPLE 2: Incoming market order to sell 200 contracts at a specific price

Book Resting Bids:

Category	Bid Qty	Fill from TPR (30%)	Fill from MI	Pro-rata pool after TPR & MI fills	Pro-rata allocation	Quantity remaining after match with incoming order	Notes
MI	100		100	0		0	2
Order 2	200			200	18	182	3
Order 3	100			100	9	91	3
LMM	100	60		40	4	36	1, 3
Order 5	100			100	9	91	3
Total	600	60	100	440	40	400	

Notes:

1. Pool of all orders = 600. LMM Pool % = $(100/600) = 17\%$, which is less than the basic 30% TPR share. Therefore, the TPR 30% share would be used, allocating the LMM 60

- contracts (30% x 200 contracts on sell order), leaving an offer quantity of 140 contracts to be filled (and leaving the LMM with an un-filled bid quantity of 40 contracts).
2. The MI gets filled on his entire 100-contract order, leaving an offer quantity of 40 contracts to be allocated pro-rata to the remaining resting orders, including the balance remaining on the LMM order.
 3. Among the remaining resting orders, each order would receive pro-rata allocation based on its percentage of the pro-rata pool. The CBOE*direct* matching engine actually allocates the pro-rata fills sequentially starting with the order with the earliest entry time and recalculating the total pool after each fill, rather than calculating all the pro-rata percentages at one time following the LMM and the Market Improver fills. As mentioned supra, the only effect of this sequential method of allocation is in cases in cases where two market participants are both entitled to an additional 1/2 contract but only one contract remains to be distributed. The remaining contract is distributed based on time or quote priority.

EXAMPLE 3: Incoming market order to sell 200 contracts at a specific price

Book Resting Bids:

Category	Bid Qty	Fill from TPR (30%)	Fill from MI	Pro-rata pool after TPR & MI fills	Pro-rata allocation	Quantity remaining after match with incoming order	Notes
MI	100		100	0		0	2
Order 2	100			100	9	91	3
LMM	300	60		240	22	218	1, 3
Order 4	100			100	9	91	3
Total	600	60	100	440	40	400	

Notes:

1. Pool of all orders = 600. LMM Pool % = $(300/600) = 50\%$, which is more than the basic 30% TPR share. Therefore, the TPR 30% share would be used, allocating the LMM 60 contracts (30% x 200 contracts on sell order), leaving an offer quantity of 140 contracts to be filled (and leaving the LMM with an un-filled bid quantity of 40 contracts).
2. The MI gets filled on his entire 100-contract order, leaving an offer quantity of 40 contracts to be allocated pro rata to the remaining resting orders, including the balance remaining on the LMM order.
3. Among the remaining resting orders, each order would receive pro-rata allocation based on its percentage of the pro-rata pool, allocated sequentially. See note 3 of Example 2.

EXAMPLE 4: Incoming market order to sell 200 contracts at a specific price

Book Resting Bids:

Category	Bid Qty	Fill from TPR (30%)	Fill from MI	Pro-rata pool after TPR & MI fills	Pro-rata allocation	Quantity remaining after match with incoming order	Notes
MI	100		100	0		0	2
Order 2	250			250	28	222	3
LMM	50	50		0	0	0	1
Order 4	200			200	22	178	3
Total	600	50	100	450	50	400	

Notes:

1. Pool of all orders = 600. LMM Pool % = $(50/600) = 8\%$, which is less than the basic 30% TPR share. Initially, the TPR 30% share would be used, allocating the LMM 60 contracts (30% x 200 contracts on sell order). However, 60 contracts are more than the total quantity of the LMM Order. Therefore, the LMM is allocated only 50 contracts, the quantity of his order, leaving an offer quantity of 150 contracts to be filled.
2. The MI gets filled on his 100-contract order, leaving an offer quantity of 50 contracts to be allocated pro rata to the remaining resting orders.
3. Among the remaining resting orders, each order would receive pro-rata allocation based on its percentage of the pro-rata pool, allocated sequentially. See note 3 of Example 2.

b. Clearing Services provided to OneChicago

Traditionally, a contract market has had only one clearing organization clear transactions executed on the contract market. The OneChicago contract market application raises novel issues in that it proposes to have OCC perform the bulk of the clearing process and provides for the CME to have a more limited role in the clearing process. This memorandum discusses the proposed clearing process in greater detail.

The proposal also would provide that the primary financial surveillance of the clearing members would be performed by their respective designated self-regulatory organization (“DSRO”), if the clearing member is a registered futures commission merchant (“FCM”), or designated examining authority (“DEA”) if the clearing member is a registered broker/dealer (“B/D”). Details of the proposed financial surveillance program are discussed below.

i. Clearing of OneChicago Transactions

A. OneChicago’s Clearing Agreements

OneChicago has entered into a clearing agreement with OCC to clear SFP transactions (the “OCC Clearing Agreement”). The OCC Clearing Agreement provides that OCC shall accept for clearing matched trades executed on the OneChicago market and submitted to clearing

by OCC clearing members. Upon its acceptance of a matched trade, OCC is substituted, as provided in the OCC by-laws and rules, as counterparty to each of the clearing members that were on the opposite sides of the matched trade.

As noted above, OneChicago is a joint venture of the CBOE, CME, and CBOT. CBOE clearing members are clearing members of OCC and therefore would be able to directly clear SFPs executed on OneChicago. However, not all clearing members of the CME are clearing members of OCC. Absent some accommodation being made, these firms would have to clear through other firms that have clearing memberships at OCC. To better accommodate the CME firms, OneChicago and OCC also have entered into agreements with CME whereby CME may clear certain transactions executed on OneChicago.¹⁰ The clearing agreement between OCC and CME recognizes the CME as an associate clearinghouse of OCC (the “Associate Clearing Agreement”). The Associate Clearing Agreement provides for the following clearing arrangements:

1. An OCC clearing member that is not a CME clearing member must clear its OneChicago SFP transactions through OCC.
2. A clearing member of CME that is not a clearing member of OCC must clear its OneChicago SFP transactions through CME.
3. If, however, the CME clearing member has an affiliate that is an OCC clearing member, the CME clearing member may clear its OneChicago SFP transactions through CME and the OCC clearing member affiliate must clear its OneChicago SFP transactions through OCC. Commencing on the first anniversary of the start of trading on OneChicago, the CME clearing member must: (a) become a clearing member of OCC and clear its OneChicago SFP transactions through OCC; or (b) direct all of its OneChicago SFP transactions to an OCC clearing member for clearing through OCC. An exception is provided if the CME affiliate is substantially larger than the OCC clearing member. In such situations, the CME clearing member may continue to clear its OneChicago SFP transactions through the CME. The Associate Clearing Agreement further provides that the CME clearing member may request an extension or exemption from the requirement that it become a clearing member of OCC or clear through its OCC clearing member affiliate if it has concerns relating to back office processing or customer-related issues that make conversion impractical or potentially harmful to the CME clearing member’s business interests.
4. A clearing member that is a member of both the CME and OCC may elect to clear OneChicago SFP transactions either through CME or OCC provided that it clears only through OCC after the first anniversary date of the commencement of trading. The clearing member may request an extension or exemption from the above requirement if it has concerns relating to back office processing or customer-related issues that make

¹⁰ BOTCC, the clearing organization of CBOT, is not an associate clearinghouse of OCC. Based upon discussions T&M staff have had with CME staff, T&M staff understands that all but one of the CBOT member firms that will participate in the OneChicago market have clearing memberships at the CME or CBOE. This one CBOT firm intends to clear through another firm that is a clearing member of CME.

conversion impractical or potentially harmful to such clearing member's business interest.

In order to clear trades, the Associate Clearing Agreement requires that the CME to maintain two clearing accounts at OCC. One account is for proprietary positions and the second account is for customer positions.

Once a trade is matched it would be presented for clearing. Pursuant to the OCC Clearing Agreement and the Associate Clearing Agreement, if two OCC clearing members are on the opposite sides of a matched trade, the trade would be cleared by OCC. In such situations, the parties to the transaction look solely to OCC for performance of the transaction. The CME does not guarantee the transaction, contribute to the OCC guaranty fund, or contribute to any assessments.

If two CME clearing members are on the opposite sides of a matched trade, the transaction would be cleared by CME. In such situations, the parties to the transaction look solely to CME for performance of the transaction. The OCC does not guarantee the transaction, contribute to the CME guaranty fund, or contribute to any assessments.

If one side of a matched trade is cleared by an OCC clearing member and the other side of the matched trade is cleared by a CME clearing member, the transaction would be cleared by OCC. The clearing agreements provide that the CME is not required to deposit initial margin on such transactions with the OCC. The CME and OCC would only transfer daily variation payments on such transactions using the CME clearing accounts at OCC. This clearing arrangement is illustrated by the following example:

Assume that Clearing Member A is a clearing member of the CME and Clearing Member B is a clearing member of OCC. If two customers' orders are matched and one side of the transaction is cleared by Clearing Member A and the other side of the transaction is cleared by Clearing B, the CME would clear the side of the transaction assigned to Clearing Member A and the OCC would clear the side of the transaction assigned to Clearing Member B. Each customer would be required to deposit initial margin with its respective clearing member. No initial margin, however, would be on deposit at the OCC.

Thereafter, each day the CME and OCC would pay or collect variation payments into the CME Customer Account maintained at OCC. Thus if the market moved in favor of Clearing Member A's customer, OCC would collect a variation payment from Clearing Member B and deposit the funds in the CME Customer Account. The CME would then collect the variation payment from the CME Customer Account and deposit it with Clearing Member A. Conversely, if the market moved in favor of Clearing Member B's customer, the CME would collect a variation payment from Clearing Member A and deposit such funds in the CME Customer Account at OCC. OCC would then transfer the funds to Clearing Member B.

If Clearing Member A defaulted on its variation payment obligation, CME would be responsible for liquidating the position and paying the obligation to OCC. Conversely, if

Clearing Member B defaulted on its variation payment obligation, OCC would be responsible for liquidating the position and paying the obligation to CME.

While the proposed clearing arrangement is novel, the Division of Trading and Markets (“T&M”) does not believe that it violates the Act or Commission regulations. OCC and CME are both registered DCOs with clearing operations and financial safeguards that the Commission has determined through previous reviews to be satisfactory.

B. CME Customer and Proprietary Clearing Accounts at OCC

The Commodity Futures Modernization Act of 2000 defines an SFP as both a futures contract, subject to the jurisdiction of the Commission, and a securities contract, subject to the jurisdiction of the SEC. In order to implement this joint jurisdiction, the Commission and SEC jointly published a proposed rulemaking in October of 2001 that would, among other things, amend Commission and SEC rules to permit a firm dually-registered as an FCM and BD to determine whether customer SFP positions must be carried in a securities account subject to the protections afforded by the SEC customer protection rules or in a futures account subject to the protections afforded by the customer funds segregation requirements set forth in Section 4d of the Commodity Exchange Act. The proposed rulemaking also provided that a dually-registered FCM/BD could elect to permit its customers to choose in which account to hold its SFP transactions. The Commission approved a final version of those rules on May 30, 2002.

CME has stated that it intends to provide clearing members that clear OneChicago transactions through the CME with the option of electing whether to carry those transactions in a securities account or a futures account. Each dually-registered clearing member that elects to offer customers a futures account and a securities account for SFP products would need to establish two accounts to hold customer margin payments. One account would be a futures account, subject to the Commission’s segregation requirements. The second account would be a securities account, subject to the SEC’s reserve requirements. The clearing members would not be able to commingle in a single account the customer funds to margin SFPs in a securities account with the customer funds to margin SFPs in a futures account. The CME also would establish two customer clearing accounts – one for SFPs in futures accounts and a second for SFPs in securities accounts.

As noted above, the ACHA Clearing Agreement provides that the CME may have one customer account at the OCC. The agreement further provides that such account shall be treated as a “segregated futures account” as defined in the OCC by-laws. Article VI, Section 3(f) of the OCC By-Laws defines the term “segregated futures account” as an account of a clearing member confined to transactions cleared and positions carried by the clearing member on behalf of futures customers. The term “futures customers” is defined by Article I of the OCC By-Laws to mean a person whose positions are carried by an FCM (whether or not the FCM is also fully registered or only notice-registered as a BD) in a futures account required to be segregated under Section 4d of the Act and Commission regulations.

The CME has informed T&M that it intends to deposit variation payments into the CME Customer Account at OCC for customer SFP positions carried by its clearing members in both securities accounts and futures accounts. Under current OCC operating procedures, all open

proprietary and customer positions are marked-to-the-market after the close. Clearing members then compute whether they have a net variation payment due from or to the OCC for both customer and proprietary accounts. If the clearing member has a payable for either account it is obligated to deposit the funds with OCC prior to the next day's opening. Variation payments to clearing members are generally made by OCC one to two hours after payments are received from clearing members.

T&M believes that the commingling of variation payments associated with customer SFP positions carried in securities accounts with payments associated with customer SFP positions carried in futures accounts does not violate the segregation requirements of Section 4d of the Act or Commission regulations. It has been the practice for many years at futures clearing organizations such as BOTCC and CME for clearing members to remit variation payments for customer and proprietary accounts to one settlement account at the clearing organization. The clearing organization is the central counterparty for every trade, whether customer or house account. Upon receipt, the clearing organization, in turn, makes payments to the appropriate accounts at clearing members on the other side of the market. Of course, any clearing member that receives variation payment from a clearing organization for customer positions carried in futures accounts is required to maintain such funds in a segregated account.

ii. Financial Surveillance of Clearing Members

Currently, each firm registered with the Commission as an FCM is assigned one self-regulatory organization as its designated self-regulatory organization ("DSRO"), which has primary responsibility for performing financial surveillance of the FCM. In addition, each firm registered as a BD with the SEC is assigned one of the securities self-regulatory organizations as its designated examining authority ("DEA"), which has primary responsibility for performing financial surveillance of the BD. Firms that are dually-registered FCMs/BDs are subject to the financial surveillance by both a DSRO and DEA. In such situations, the DSRO and DEA would generally consult with each other as part of their routine financial surveillance program.

As previously noted, each clearing member of OneChicago must be a clearing member of either the CBOE or CME. The OneChicago proposal would provide that the primary financial surveillance for these clearing members would be performed by the respective firm's DSRO and/or DEA. Furthermore, CBOE staff have stated that they expect that most, if not all, of the CBOE member firms that currently are not registered as FCMs would register with the Commission as FCMs in order to provide customers with the choice of electing to carry their SFPs in futures accounts as well as securities accounts.

c. *Anti-competitive Issues Regarding Clearing Service Agreements*

OneChicago has contracted with OCC to serve as a clearing organization. In addition, to accommodate members that are "not clearing members of OCC or because the systems through which they send trades to OCC are not the systems they use for futures contracts,"¹¹ OneChicago has arranged for those members to clear trades through CME under the following circumstances

¹¹ See OneChicago's Responses dated March 28, 2002, at 23, question (a).

As stated above, the parties have agreed to the following clearing arrangements:

- OCC clearing members must clear trades through OCC.
- CME clearing members who are not clearing members of OCC must clear through CME.
- OCC clearing members with affiliates that are CME clearing members must clear through OCC. The affiliates may clear through CME until OneChicago's first-year anniversary. After one year clearing must go through OCC (but a CME clearing member can request an extension or exemption due to (1) concerns relating to back office processing or customer-related issues that make conversion impractical or potentially harmful to the CME clearing member's business interests, or (2) if the CME affiliate is substantially larger than the OCC clearing member).
- OCC clearing members who also are CME clearing members may clear through either entity until OneChicago's first-year anniversary. Then, clearing must go through OCC (but a clearing member may request an extension or exemption due to concerns relating to back office processing or customer-related issues that make conversion impractical or potentially harmful to such clearing member's business interest).

This arrangement is intended as an accommodation to those members for which pursuing OCC clearing membership would involve added expense and potentially significant changes to internal systems and procedures. This flexibility should help preserve the opportunity for FCMs that are not OCC members to participate in this marketplace without being disadvantaged relative to BDs that are OCC members. Consistent with the arrangement's intended purpose as an accommodation to CME members that are not OCC members, OneChicago has agreed not to solicit CME members to clear trades through CME rather than OCC for the term of the OCC and OneChicago service agreement.¹² In the same agreement, OneChicago has agreed not to charge less fees on trades cleared on CME rather than OCC.¹³ In the agreement between OCC and CME, CME agrees that during the term of the agreement it would not actively solicit CME clearing members to clear OneChicago transactions through CME rather than OCC.¹⁴ This provision does not have an expiration date.¹⁵

OneChicago contends that these provisions are necessary to provide convenience to CME members who desire to clear trades through CME. More specifically, the ability to clear security futures through CME would accommodate clearing members and exchange members who are "not clearing members of OCC or because the systems through which they send trades to OCC are not the systems they use for futures contracts."¹⁶ OneChicago explains that the no solicitation clause was a "prerequisite" to allowing OneChicago the ability to offer a choice.¹⁷

¹² See Appendix D-2 (Service Agreement between OCC and OCX, Section 14) at 12.

¹³ *Id.*

¹⁴ See Appendix D-3 (Service Agreement between OCC and CME, Section 8(e)) at 6.

¹⁵ See OCX's Responses dated March 28, 2002, at 23, question (a).

¹⁶ See OneChicago's Responses dated March 28, 2002, at 23, question (a).

¹⁷ *Id.* at 15, question 17(a).

OneChicago also explains that even though there are restraints on OneChicago and CME, the restraints are reasonable because they “preserve the freedom of market participants.”¹⁸ OneChicago further states that “offering a choice between clearing locations to qualifying market participants is inherently pro-competitive, and unprecedented in the context of exchange-traded futures contracts today.”¹⁹

While this is a novel clearing arrangement for the Commission and the industry, OneChicago has offered a reasonable explanation for the clearing arrangement detailed in the service agreements with CME and OCC. For example, as stated above, we understand that this is an accommodation for CME members, allowing CME members to clear these products without having to join OCC and thus providing greater market access. OneChicago’s explanation suggests that the actual effect of the clearing arrangement will not create an unreasonable restraint on trade or impose any material anticompetitive burden on trading consistent with Core Principle 18. Accordingly, staff concludes that One Chicago’s clearing arrangement demonstrates compliance with applicable core principles and designation criterion.²⁰

d. SIAC Agreement

OneChicago states that the Securities Industry Automation Corporation (“SIAC”) would serve as the central collection agency for large trader data for customer accounts, providing access to its equity audit trail file, on a daily basis, to the CME on behalf of OneChicago. However, the agreement between OneChicago and SIAC has not been executed. According to the Exchange, SIAC would consolidate large trader information from CME member firms, CBOE firms, and BOTCC member firms, and provide it to the CFTC and CME (as well as other SROs). This data, in conjunction with data that would be provided directly to the CME, would be used to populate the CME’s large trader database. As OneChicago is in the process of contracting with SIAC, the Commission should condition its designation of OneChicago upon the provision of a copy of an executed agreement between OneChicago and SIAC, that provides for the consolidation of such information and its provision to OneChicago and/or the Exchange’s delegatee (currently CME).

e. Exchange Governance Provisions

The Divisions have determined that the Exchange should make a part of its Rulebook, those governance provisions regarding the powers, responsibilities and limitations on those governing the Exchange, as for example provisions regarding the Directors’ powers, meetings guidelines,

¹⁸ See OneChicago’s Responses dated May 7, 2002, at 14, question 17(a).

¹⁹ See OneChicago’s Responses dated May 7, 2002, at 14, question 17(a).

²⁰ Even though the Commission is not approving vendor agreements as part of the contract market application, it should be aware that the Department of Justice has recently initiated an investigation into whether BrokerTec Global LLC has participated in unfair practices to thwart competition on its on-line trading platform. See <http://www.usatoday.com/life/cyber/invest/2002/05/17/online-trade.htm>.

voting restrictions and guidelines, qualifications of directors, indemnification of directors and officers, and members' fee structure. However, the Exchange would not be able to complete the adoption of such provisions prior to designation. Therefore, the Commission should condition its designation of OneChicago upon the determination of staff that the Exchange has adopted additions to its Rulebook that provide the Exchange with appropriate governance provisions regarding the powers, rights, responsibilities and limitations on those governing the Exchange.

V. Attachments

- A. December 21, 2001 Application Letter from OneChicago to the Commission
- B. OneChicago Application Index, dated June 4, 2002
- C. OneChicago Application, dated May 7, 2002
- D. OneChicago Rulebook, dated May 20, 2002
- E. OneChicago Policies and Procedures, dated May 20, 2002

The other background materials are available to the Commission upon request