Integrated List of Commodity Futures Trading Commission ("Commission") Staff Questions Concerning the Application of U.S. Futures Exchange, L.L.C. ("US Exchange") for Designation as a Contract Market

Agreement and Bylaws

1. Section 5.2(a) provides that there will be one Director on the Board of Directors. How will the Exchange address a situation in which that Director has a conflict of interest? Will the Exchange limit itself to one Director after its start-up phase? Please discuss any plans to expand the Board of Directors.

> **US Exchange will not operate with a single Board member. In accordance with US Exchange's Agreement and Bylaws and prior to the commencement of trading, the Board of Directors will be expanded, most probably to twelve Directors. Overall the Board composition will be balanced, representing all segments of Exchange participants. We expect that the Board will meet in the United States and that a majority of the Directors will be United States citizens or located in the United States.**

2. With respect to governance fitness standards, please describe the procedure that the Exchange will use to detect persons subject to the conditions listed in Section 5.6(a). How will the exchange verify information collected from individuals pursuant to Section 5.6(b)? How will the applicant substantiate fitness information to the Commission (e.g., by certification or affidavit of counsel)? What are the applicant's fitness standards for members of the limited liability company that are natural persons with an ownership interest, direct or indirect, of ten percent or greater?

> **US Exchange will conduct an independent inquiry to substantiate the fitness information that directors will be asked to provide, including verification of fitness using the BASIC and other similar databases. Directors will be asked to certify that they meet the governance fitness standards and these certifications will be provided to the Commission.**
>
> **US Exchange does not have shareholders of the L.L.C. that are natural persons and does not anticipate having natural persons with an ownership interest of ten percent or greater. US Exchange will notify the Commission in the event that natural persons assume an ownership interest in US Exchange.**

3. Will the Exchange enter into appropriate information-sharing arrangements, such as the International Information Sharing Memorandum of Understanding and Agreement of March 15, 1996 (Boca Declaration)? Will the Exchange agree to participate in the

Commission's Exchange Database System project by routinely providing trading information to the Commission?

> **US Exchange will enter into appropriate information-sharing arrangements, including the International Information Sharing Memorandum of Understanding and Agreement of March 15, 1996.**
>
> **US Exchange will participate in the Commission's EDS project and will provide trading information to the project.**

4. What is a majority of the Board as mentioned in Section 6.5(a) of the Bylaws. (e.g., if the Board has an even number of directors, will 50% be a quorum, or some greater number)? What is a majority of a committee, as mentioned in Section 7.2(b)?

> **A quorum of the Board and committees thereof will consist of 50% or more, with a majority being 51% of those present and participating. In the event that the Board has twelve Directors, six Directors will constitute a quorum of the Board and seven will constitute a majority of the Board.**

5. Section 9.11(a)(i) of the Bylaws bars an employee or consultant from trading for his or her account or those of others "in any commodity interest, on the basis of any material, non-public information…" Please address the apparent inconsistency between this prohibition on trading and the prohibition established in Rule 207(a)(i) and (b).

> **An employee or consultant must comply with both section 9.11 of the Bylaws and Rule 207. To the extent one could be construed as establishing a stricter standard, that standard must be adhered to.**

6. What records will be maintained by the Exchange? The Services Agreement states at 10.4 that Eurex and the Exchange will keep "full and true book of accounts and other records" for a period of ten years, and that access to the records will be provided upon receipt of a reasonable request. It does not state exactly what information will be kept. Would the Exchange maintain records in accordance with Commission Regulation 1.31?

> **US Exchange and those providing services relating to core regulatory functions will retain all audit-trail related records, records related to Membership admission and disciplinary actions, records related to the regulatory functions of trade practice and market surveillance and associated investigations and actions resulting therefrom, all records relating to exchange and corporate governance and all routine business-related records which are kept as a matter of custom.**

US Exchange and those providing services relating to core regulatory functions and exchange operations to US Exchange will comply with Commission Regulation 1.31 at all times.

<u>Exchange Rules</u>

1. Rule 203, which authorizes and describes the Disciplinary Committee, provides that no employee of the Compliance Department of the Exchange may serve on the Disciplinary Committee. Does this prohibition apply to staff of the third-party self-regulatory organization that would be under contract to investigate and prosecute disciplinary cases?

Rule 203 states that appointees to the Disciplinary Committee will be officers and employees of US Exchange. Furthermore, for purposes of Rule 203, the Chief Executive Officer will consider employees of any contractor performing regulatory services for the Compliance Department to be covered by the Rule's prohibition on staff of the Compliance Department serving on the Disciplinary Committee.

Please describe the criterion that the Exchange would use in making appointments to the Disciplinary Committee.

Under the Rule, US Exchange's Chief Executive Officer appoints Exchange officers or employees to serve on the Disciplinary Committee. Such individuals would be senior level employees, with an appropriate degree of experience to perform this function. Only individuals who would not be statutorily disqualified under §8a(11) of the Act if applying for registration and who do not have a significant history of serious disciplinary offenses such as those listed as disqualifying under §1.63 would be eligible for consideration to serve on US Exchange's Disciplinary Committee.

2. Rule 205 authorizes and describes the Compliance Department. Assuming that the NFA conducts the regulatory duties for the Exchange, what would be the composition of the Compliance Department? Elsewhere, the submission refers to the Market Supervision Department. Should there be a provision within Part 2 of the Rules describing the authority and duties of the Market Supervision Department? Should there be a provision describing the relationship between this department and the Compliance Department? What would be the composition of the Market Supervision Department?

Initially the Compliance Department will consist of a Chief of the Compliance Department. The Chief's function will be to make those determinations requiring the exercise of discretion that have been reserved and not included in the regulatory services contract with NFA. The NFA has been retained to conduct trade practice and market surveillance on behalf of

US Exchange. Contracting with a registered futures association, such as NFA, for regulatory services is specifically contemplated under section 5c(b) of the Act, and the regulatory services contract between US Exchange and NFA complies in all respects with the Commission's Application Guidance, 17 CFR part 38, Appendix B, Core Principle 2.

US Exchange and the NFA understand and take seriously their obligation to have sufficient and adequate staff to carry out their self-regulatory functions. Current staffing levels are based upon NFA's experience in providing such services to other designated contract markets. Both the NFA and US Exchange will add personnel as increasing volume requires. The Commission, through its Rule Enforcement Program, will have an opportunity to evaluate on an on-going basis, US Exchange's staffing in relation to increasing trading volume and to recommend that US Exchange take corrective action in the unlikely event that US Exchange's staffing fails to keep pace with market growth.

Market Supervision functions are conducted by Exchange employees. These functions relate to administration of the trading platform. These employees do not exercise disciplinary authority. Accordingly, it is unnecessary that their functions be provided separately by rule. The Market Supervision staff will include approximately 13 persons, including supervisors.

Market Supervision staff will communicate to NFA promptly and on an on-going basis any information that may assist NFA in the performance of its regulatory activities. However, there is no need for a special provision regarding the relationship between Market Supervision staff and the Compliance Department. All exchange employees, including those in Market Supervision, have the authority to make referrals to the Compliance Department if they have reason to believe that a violation of exchange rules has occurred. Similarly, Compliance staff may obtain information from any exchange staff member (other than clerical staff members), in furtherance of an inquiry into alleged violations of exchange rules.

3. Rule 205 establishes authority of the Exchange Compliance Department over market surveillance. The draft Regulatory Services Agreement with NFA has NFA performing market surveillance responsibilities under contract with the Exchange. Please describe the respective responsibilities of the Exchange Compliance Department and NFA with respect to market supervision, real-time market surveillance, and market surveillance generally.

NFA will perform surveillance for trade practice violations and for market manipulation, price distortions or market congestion. NFA will have transaction data available on a T+1 basis for this purpose. US Exchange's Market Supervision staff will conduct real time supervision of the market

with respect to cancellation of trades, invocation of the volatility procedures, trading suspensions and maintenance of proper operation of the Trading System, including oversight of the Opening Procedures, checking for validity of Orders entered into the Trading System, and the appropriate editing of information during the Post-trading phase.

4. Will the Exchange's real-time surveillance be conducted in Chicago or outside the US (in Frankfurt)? If performed outside the US, will there be a record of surveillance interventions kept for review in US?

US Exchange's real time surveillance for regular exchange trading hours will be conducted completely from Chicago. Eurex Frankfurt will offer a back-up facility should it be required. Surveillance outside normal U.S. business hours on US Exchange will also be conducted out of Chicago and will be supported as necessary by the Frankfurt facility. Records of interventions in the US Exchange market made by the Frankfurt facility, if any, will be kept both in the U.S. and in Frankfurt.

Construction is already underway on US Exchange's Chicago headquarters. The Chicago Market Supervision facility will be fully operational by the time trading begins.

5. Please provide the approximate number of staff expected to be assigned to the Exchange Compliance Department, and their general qualifications. Please provide the same information with respect to NFA's Market Surveillance staff expected to be assigned to the Exchange. Please explain how each of the projected staffing levels was determined.

At the time of launch, US Exchange's Compliance Department will consist of a Chief of the Department. This individual will also act as General Counsel for US Exchange. The individual who will be performing these duties is an attorney who has been duly admitted to a state bar and who has a number of years of futures regulatory experience. Additional personnel will be added as increasing volume requires.

A total of 5 NFA staff initially will be assigned to perform regulatory services for US Exchange. Although NFA performs regulatory services for additional markets, these individuals will be performing such services primarily for US Exchange. These individuals are NFA's trade practice and market surveillance staff, which consists of a manager and two senior managers. One senior manager has 17 years of experience with NFA, an MBA and is series 3, 7 and 4 licensed. The other senior manager has worked at NFA for 3 years and previously at the Chicago Board of Trade for five years. The manager's experience at the Chicago Board of Trade was chiefly with investigations and for a shorter period of time with the a/c/e Market

Supervision desk. The manager has 2 years experience at NFA, has also worked at the CBOT in OIA for approximately 5 years, and has 15+ years of futures trading experience. This manager is series 3, 7 and 4 licensed. The entire department is overseen by the senior vice president who has headed NFA's compliance department for 3 years and previously had over 20 years of experience at CBOT in several positions, including senior vice president of OIA. Also, NFA has a Compliance Department of approximately 90 individuals, many having training, or first hand experience working, in Market Surveillance, who will be drawn on as additional staff resources are needed and increasing volume requires.

As noted above in response to Question 2, US Exchange's and NFA's initial staffing levels are based upon management experience. To the extent additional or reduced staffing becomes appropriate, staffing levels will be adjusted over time

6. Rule 207 addresses restrictions on Directors, Officers, Committee Members, Employees and Consultants. Please describe what is meant by the term "significant action" as that term is used in, e.g., Rule 207(d)(iii), (iv), and (vi). Also, please address the apparent inconsistency in Rule 207(d)(vi) in that Rule's reference to Rule 207(d)(i) and (iii), which prohibit participation for different reasons (the former for a personal relationship, the latter for a financial interest).

"Significant action" was intended to denote substantive action of a non-trivial or non-ministerial nature. "Significant action" includes rule changes that address a market emergency and any changes to margin levels or other action likely to have a substantial effect on prices for any product traded on US Exchange that is taken in response to extraordinary or disorderly market conditions.

The reference in the third line of sub-paragraph (d)(vi) of Rule 207 to "paragraph (i)" is a typographical error, and should read "paragraph (iii)."

7. Under Rule 307(b)(ii), members are required to inform the exchange of "any expulsion, suspension or fine in excess of $25,000 … imposed by any SRO." Please explain the rationale for setting the fine threshold at $25,000.

Under Rule 307(b), Members must notify US Exchange of a number of adverse actions by a Governmental Agency or other self-regulatory organization that might affect the Member's fitness for continued Membership in US Exchange. These include any expulsion, suspension, refusal of admission or withdrawal of an application for admission by the Member to another SRO, and any fine in excess of $25,000. US Exchange believes that a violation of another SRO's rules which results in a fine above

$25,000 may be of a sufficiently serious nature to merit consideration by US Exchange of the Member's status.

8. Rule 307(d) requires members to keep records of all transactions for a total of five years and such records must be readily accessible for the first two years. Please confirm that this rule requires that the member retain unfilled, changed, and canceled orders.

Rule 307(d), consistent with the CFTC's guidance in 17 CFR Part 38, Appendix B, Core Principle 10(b)(2)(i), includes the obligation that Members retain records of unfilled, changed and cancelled orders.

9. Rule 307(n) requires that each member ensure, to the extent possible, that each order received from a customer which is executable at or near the market price be entered into the trading system before, among others, proprietary orders. Please define the meaning of "near" in this context. In addition, please describe how the Exchange will check to see if orders have been improperly withheld. The NFA would review proprietary orders being entered near customer orders in response to any customer complaint regarding the quality of the fills they receive, or review such orders during back-office audit reviews. How often will these back office reviews be done and what specifically will the back office reviews involve? Would this be a different review than the financial compliance reviews conducted by DSROs?

The meaning of "near" must be determined by reference to what is reasonable within a given context. Certainly, the size of the bid/ask spread is a factor that must be considered in understanding the particular context. In this regard, any order that is within a tick of the current bid/ask spread would be considered to be "near" the market. Orders that are greater than one tick above or below the current market might also be considered to be "near" the market in a market that is trending in that direction, or in a market with a relatively wide bid/ask spread. On the other hand, orders that are several ticks away from the current market might not be considered to be "near" the market where the market has been trending the direction opposite to the order, or in a market with a relatively narrow bid/ask spread.

US Exchange has contracted with NFA to surveil for such trade practice violations. NFA will review audit trail data to determine whether orders have been improperly withheld by comparing the time an order was received by an FCM with the time it was entered into the trading system and the time of entry of any intervening proprietary order. Surveillance will take place in the first instance in response to any customer complaints regarding the quality of the fills they receive on orders. Secondly, NFA will monitor for withheld orders using three different methods.

The first two include the automated generation of exception reports that identify crossed orders and that identify paired counter party trade

percentage. Crossing orders allows one to see the timing of the buy and sell side of orders that have been exposed to the market. The counter party percentage identifies users with a high percentage of trades between two parties. Moreover, NFA could look at the order execution time and request the office order documentation to see if the firm executed a trade for itself in advance of a customer order that has been placed through the same firm. Lastly, if any unusual activity is found in the order book as captured in the NFA's Trade Analysis and Profiling System, the staff will request order tickets and order routing information to see the timing of the transactions in relation to the proprietary activity of the firm.

This surveillance activity is in addition to the financial compliance reviews that are conducted by the DSRO. This activity is also reviewed as part of the DSRO examination process. NFA has been retained to conduct such DSRO examinations on behalf of US Exchange to the extent that US Exchange is required to conduct such examinations.

10. Under Rule 313(a), the Exchange may permit a member to use an AORS to input orders as authorized and on prescribed terms and conditions. Please describe those appropriate "terms and conditions."

Members must apply to US Exchange for permission to connect automatic order routing systems to the Trading System. Approval of an application for permission to connect an AORS to the system is dependent upon the Member meeting the following conditions. The AORS must operate using the properly defined interface. Moreover, the AORS must provide that before orders are channeled into the Trading System, they pass through an electronic filter resident on the AORS, which checks and releases orders for further transmission according to the parameters defined by the Member. The Member must be responsible for controlling and monitoring the filter and be able to prevent the forwarding of orders at any time. Finally, the Member must provide identifying information to US Exchange relating to those individuals authorized to enter orders over the Member's AORS.

11. Will a membership termination proceeding pursuant to Rule 314(a)(ii), for members who no longer meet the eligibility standards in Rule 302, be conducted pursuant to Rule 615, Member Responsibility Actions? If not, please explain how the provisions of Rule 314(a)(ii) would provide for adequate due process protections and why the due process protections specifically provided in Rule 615, including a written decision, need not be provided.

No, Rule 314(a)(ii) reserves to US Exchange the right to terminate Membership, and thereby access to the Trading System, using procedures other than those provided in Part 6, where US Exchange determines the Member no longer meets one of the eligibility standards set forth in Rule 302.

For example, US Exchange could terminate an FCM's Membership under the provision of Rule 314(a)(ii) if the FCM has been barred by the Commission from conducting business as an FCM. Such a bar would make the FCM ineligible for Membership under Rule 302(a)(v). In such a case, US Exchange could terminate the FCM's Membership upon determining that the FCM no longer meets the eligibility requirement, after providing notice to the Member and an opportunity to be heard.

Will the Exchange initiate membership termination proceedings against members who become subject to any of the conditions for denial of an initial application in Rule 304?

US Exchange would consider terminating the Membership of Members who became subject to the conditions for denial of initial Membership on a case-by-case basis. For example, Rule 304(a)(iv) makes being subject to a disciplinary action by any SRO a basis for denial of Membership. Such a termination procedure would be subject to the procedures of Chapter 6 of US Exchange's Rules. It would be unlikely, however, that US Exchange would terminate an entity's Membership where the disciplining SRO has determined that the violation merited a less severe sanction.

12. Rule 401, Business Day Periods, does not clearly indicate when the trading day will start. Does the trading day start the evening before, or on the actual business day?

The trading day will begin at 8 p.m. Central Time on the day prior to the beginning of the actual business day.

13. Rule 401(b) states that "trading begins with the determination of an opening price for each futures delivery month and each series of futures options." Please describe how that opening price is determined and by whom? Please also describe how the Exchange determines the "preliminary opening price" referred to in paragraph 401(b)(i) and the "final opening price" referred to in paragraph 401(b)(ii). In addition, while Rule 401(b)(iii) refers to the Opening Period ending as soon as the netting process has been completed, it is unclear whether the netting process result is actual trade-matching (if possible) or whether there is merely an opening price determination. Please clarify this point.

The opening price is determined by the Trading System through the interaction of orders and quotes entered into the Trading System during the pre-Trading and Opening periods. In essence, the opening price is determined by the Trading System, which aggregates all orders and quotes entered before trading begins and, based on those orders and quotes, determines the price at which the maximum number of contracts can be, and are, matched. That price is the opening price, referred to in Rule 401(b) as the "final opening price."

Specifically, the Trading System calculates a preliminary opening price based upon orders and quotes received during the Pre-trading period. The preliminary opening price reflects the price that would be determined if the opening matching process described above were to take place immediately. The preliminary opening price is displayed continuously once the pre-opening period begins. The preliminary opening price is updated to reflect additional orders and quotes entered into the system. At the end of the pre-opening period, the Trading System enters a transition and a netting period to obtain a single opening price for each futures contract month and each series of futures options. The Trading System calculates the opening price, and matches those trades, by matching the maximum number of contracts from the orders and quotes that have been entered into Trading System for that futures or options. That price is the Opening Price. Following the Opening Period, trading begins using the applicable price/time priority or pro-rata matching logic.

14. Rule 401(e) addresses the post-trading period. Pursuant to Rule 401(e)(i), during the post-trading full period, the trading system is available to members for data requests as well as input of data changes. Please describe what data requests may be made and what data may be changed.

During the Post-trading Full Period Members may inquire regarding information on trades executed during the trading period (Online Time&Sales), statistical information such as market volume and the high and low. Members may also inquire regarding their own active orders, and access the audit trail for their own orders and trades.

The trading functions that are available to Members during Post-trading Full Period are similar to the functions permitted during Pre-trading. The system accepts additions, changes and deletions of unrestricted limit orders, market orders, stop orders and quotes for the next trading day. No matching of orders takes place and there are no broadcasts of inside market changes. Traders see only the best bid and ask prices at the close of trading.

During the Post-trading Full Period, US Exchange suggests to the Clearing Organization settlement prices for all contracts.

For more information, concerning the actions that are possible in the Post trading Full Period please refer to the table below. The table distinguishes which actions can be performed by US Exchange (Market Supervision) or the Members.

There are four access levels defined:
0: No access is allowed

1: Inquiry access only is allowed
2: Inquiry, Add, and Change access is allowed
3: Inquiry, Add, Change, and Delete access is allowed

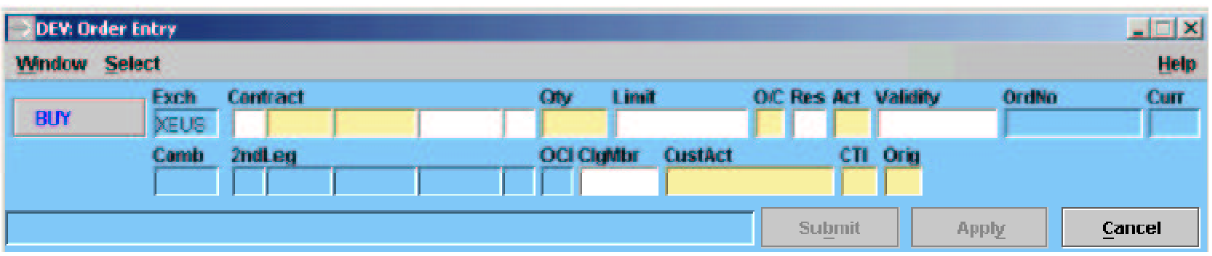
Please see the following table.

[redacted]

15. Rule 403 addresses the entry of orders into the trading system. Will the order entry requirements include the account identification for a customer order? Does the field "CustAct', Customer Account Name, require an account number, or can the customer be identified in some other manner?

The customer account number is a mandatory field that is required to be entered for each order.

Identification of customer orders and CTI codes are required when entering orders into the Trading System. The order entry specifications and fields are as follows:



Fields	Field Name	Description
Exch	Exchange	• Exchange Identifier
Contract	Contract	• Contract identification • Futures – Underlying, expiration month and year • Options – Call/Put, underlying, expiration month and year, strike price, version number
Qty	Quantity	• Pre-filled with a default quantity if the user configured Default Quantity Setting in the *Limit/Quantity Configuration* window • Using the up or down arrow key will fill the field with a quantity • Supports a maximum quantity of 9,999
Limit	Limit Price	• Required for combination and stop orders • Market Orders – leave limit field empty • Pop-up list displays defined increments when user has defined limit increments in the *Limit/Quantity Configuration* window • Using the up or down arrow key will fill the field with a price
O/C	Open/Close	• Code used to post matched trade to position

<table>
<tr><th>Fields</th><th>Field Name</th><th>Description</th></tr>
<tr><td></td><td>indicator</td><td>• Valid Open/Close Indicators:
O – Open
C – Close
R – Simultaneously close front month and open back month position for futures combination</td></tr>
<tr><td>Res</td><td>Restricted order type</td><td>• This is a mandatory field for option combination orders.
• Valid Restriction Codes:

I – IOC (Immediate or Cancel) Valid for futures and option combinations
Default value for options combinations

F – FOK (Fill or Kill)
Valid for options only

S – Stop
Valid for single leg futures only</td></tr>
<tr><td>Act</td><td>Account Type</td><td>Act requirements:
• Use A1 (default)
• Use G1 for a give-up and no house number for multi-firm give-ups
• Use G2 for a give-up with a house number for single firm give-ups</td></tr>
<tr><td>Validity</td><td>Expiration of order</td><td>• GFD – Good for Day (default)
• GTD – Good till Date, a Validity Date has to be selected
• GTC – Good till Cancelled
• Using the up or down arrow key will fill the field with a date</td></tr>
<tr><td>OrderNo</td><td>Order number</td><td>• System assigned number when order is entered into system
• Identifies the order.</td></tr>
<tr><td>Curr</td><td>Currency</td><td>• Currency code for selected product
• This is a display <u>only</u> field and is filled by the system.</td></tr>
<tr><td>Comb</td><td>Combination order</td><td>• Required for combination orders
• Indicates combination type<table><tr><th colspan="2">Futures</th></tr><tr><td>SPD</td><td>Calendar spread</td></tr><tr><th colspan="2">Options</th></tr><tr><td>BUL</td><td>Vertical Bull Spread</td></tr></table></td></tr>
</table>

<table>
<tr><th>Fields</th><th>Field Name</th><th colspan="2">Description</th></tr>
<tr><td rowspan="6"></td><td rowspan="6"></td><td>BER</td><td>Vertical Bear Spread</td></tr>
<tr><td>BLT</td><td>Bull Time Spread</td></tr>
<tr><td>BRT</td><td>Bear Time Spread</td></tr>
<tr><td>STD</td><td>Straddle</td></tr>
<tr><td>STG</td><td>Strangle</td></tr>
<tr><td>CNV</td><td>Conversion/Reversal</td></tr>
<tr><td>2nd Leg</td><td>2nd leg contract</td><td colspan="2">• Required for combination orders
• Futures – underlying, expiration month and year
• Options – Call/Put, underlying, expiration month and year, strike price and version number</td></tr>
<tr><td rowspan="4">OCI</td><td rowspan="4">Option combination</td><td colspan="2">• Required for combinations
• Specifies which order to match against:</td></tr>
<tr><td>Symbol</td><td>Book</td></tr>
<tr><td>B</td><td>Regular</td></tr>
<tr><td>Q</td><td>Option Combination Quote Book</td></tr>
<tr><td>ClgMbr</td><td>Clearing member firm</td><td colspan="2">• Identifies the take-up member for an order specified as pre-designated for give-up
• Required if G2 account</td></tr>
<tr><td>CustAct</td><td>Customer account name</td><td colspan="2">• Required field
• Identifies customer account
• Pop-up list displays accounts defined in Account Configuration window
• If the user selects a predefined account, the system fills in the respective account information</td></tr>
<tr><td>CTI</td><td>Customer Transaction Indicator</td><td colspan="2">Required field
Valid Customer Transaction Indicators:
1 – Own Account
2 – Proprietary
3 – On Behalf of Other Members
4 – Other Customer</td></tr>
<tr><td>Origin</td><td>Clearing details</td><td colspan="2">Required field
Valid Origin Codes:
1 – Customer
2 – Non-Customer
3 – Other Member
4 – Broker</td></tr>
</table>

In addition, are there any documentation requirements that must be met when a customer order that cannot be immediately input into the trading system is received?

Rule 307(d), consistent with the Commission's guidance in 17 CFR Part 38, Appendix B, Core Principle 10(b)(2)(i), includes the obligation that members retain records of unfilled orders.

16. Rule 403(b)(vii)(C)(3) refers to inter product spread stop orders. Please describe how spread stop orders would be elected.

An inter product spread (IPS) is set up like a futures contract where the price is defined by the price differential of its two components. Members can enter Market, Limit or Stop Orders into the Trading System. Limit or Stop Orders are entered with this differential price. Stop orders in such a product can only be triggered by trades in the inter product spread itself. There is no link into the order books of the spread's components, and more particularly, there is no function to survey the price differential of the components in order to trigger stop orders in the IPS.

17. Please describe how the Exchange will address cascading fills of stop orders in a thin market.

Exchange Rule 409 "Volatility Interruption" addresses the issue of cascading orders in a thin market. This Rule, which is similar in concept and operation to the "circuit breaker" rules that are in place for some futures markets, provides a defined procedure for interrupting cascading orders in futures markets caused by a temporary liquidity vacuum and for the orderly restart of trading. Specifically, Rule 409 provides that US Exchange may interrupt a trading session if the price moves outside of a very broad price range within a specified time-frame, which is determined by US Exchange, in its discretion. If a contract's last traded price crosses this threshold level US Exchange interrupts the trading session and restarts trading with the Pre-trading and Pre-opening Periods. This results in the aggregation of orders and quotes and the determination of an orderly market price.

In addition to Rule 409, a number of the electronic validations that are routinely performed on orders when entered into the system serve to discourage the cascading of stop orders in a thin market. These include a validation regarding the size of orders and one restricting the entry of limit orders too far away from the last traded price.

18. Rule 403(c) addresses strategy board trading. Please describe any limits with respect to which strategies are permissible.

> **The Trading System provides for 45 predetermined types of combination trades. Traders are limited to these predetermined types of strategies. Eighteen of these are option volatility strategies involving the underlying futures contract. The trader enters the price and size of the futures leg of the strategy combination into the Trading System. The price that the trader specifies may not be more than 1% below or above the last traded price in the market. Option strategies include, among others, various types of butterfly spreads, calendar spreads, ratio spreads, and volatility spreads.**

19. Rule 404 describes the execution of transactions. Please confirm that under the price pro-rata priority algorithm, orders at the best price would have first priority and orders at the same price would be matched pro rata in accordance with the respective quantities of the orders. Under the price pro-rata algorithm, please explain how the algorithm would assign "partial" contracts (e.g., Trader A's and Trader B's respective pro rata portions are not whole numbers).

> **That is a correct general statement of the pro rata priority algorithm. Under the Pro Rata Matching Principle, if the total order volume of best price orders and quotes contained in the order book exceeds the volume of an incoming order or quote, the orders and quotes contained in the order book will, after rounding down to form a whole contract, first be allocated to and matched with the incoming order and quote on the basis of the percentage share they represent of the total order volume available in the Trading System at such price. To the extent that the incoming order could not be fully allocated and executed on this basis, the portion thereof that could not be executed will be randomly allocated to and matched with the orders and quotes contained in the order book.**
>
> **If the total order volume of best price orders and quotes contained in the order book does not exceed the volume of the incoming order or quote, the best price orders and quotes contained in the order book will be fully allocated and executed. That portion of the incoming order or quote that could not be executed will be matched according to the Pro Rata Matching Principle.**

20. Rule 406 addresses cross trades and prearranged trades. Rule 406(b) requires that a member seeking to match customer orders, to take the opposite side of a customer order, or to execute a pre-negotiated transaction wait 5 or 15 seconds, depending upon the type of contract, after the initial order is entered into the trading system before entering the opposite order. Please describe what is meant by the terms "initial" and "opposite" order in the context of this rule. Would cross trades and prearranged trades executed

pursuant to Rule 406 also be subject to the requirements of Rule 307(n) concerning priority of customer order entry?

An initial order means the order with the earlier timestamp from either side of the trade. When the buy (sell) side is entered earlier in the ETS then the sell (buy) side of the trade is considered the opposite order. Trades entered under the provisions of Rule 406 remain subject to the provisions of Rule 307(n) which grants customers priority of order entry. Accordingly, the initial order is always the customer order.

21. Rule 408 addresses the cancellation of transactions. Please describe how the Exchange would determine how the price of a transaction effected on the trading system deviates "significantly" from its fair market price under Rule 408(a). Please describe how the Exchange would document the decision-making process involved in the cancellation of transactions. Would any such documentation be retained in accordance with Commission Regulation 1.31? Please confirm that the Exchange would not cancel any transactions under Rule 408 for entry of an erroneous quantity, unless the transaction also had an erroneous price.

US Exchange will determine in its discretion whether a price deviates "significantly" from its Fair Market Price based upon management experience and expertise in market oversight. Management will consider a number of factors in making such a decision, including the number of ticks by which the price has moved and the volatility or lack thereof in market price for the underlying commodity. In any event, no price would be determined to be "significantly" away from its fair market price unless it is outside of the relevant "mistrade" price range identified in Rule 405(b)(ii). The "mistrade" price range is a defined price range inside of which trades will not be cancelled. Rule 408 also provides guidance in how Fair Market Price is determined. Under the rule, Fair Market Price most often will be the last traded price. However, in instances where the last traded price may not be representative of Fair Market Price, in illiquid markets or if the underlying market has moved for example, Rule 408, as modified, provides explicit procedures by which Fair Market Price will be determined.

The Market Supervision Unit will keep logs of the actions it takes in administering the mistrade rule. These logs will document all relevant facts surrounding the individual circumstances when Rule 408 is invoked, including but not limited to the parties requesting the cancellation, the time that the cancellation was requested, the information relating to the traded price and the market price for trades immediately preceding the trade which have been requested to be cancelled and US Exchange's action.

The documentation of the decision-making would be retained in accordance with Commission Regulation 1.31. Under Rule 408, US Exchange would not

cancel a transaction within the mistrade price range because the entry of the volume was erroneous.

22. Rule 408(b) does not seem to give any discretion to the Exchange to refuse to cancel a transaction which satisfies the conditions of Rule 408(b)(i) and (ii). Please confirm this interpretation of Rule 408(b).

That is correct.

23. With respect to Rule 408(f), please explain the meaning of "counter-transaction" and describe the procedures that would be followed in cancelling a transaction, including the manner of publication on the trading system.

A counter-transaction is an administrative order to the Trading System cancelling a previous transaction. A party's request to cancel a transaction based upon an erroneous entry of an order will be considered by the Market Supervision Unit. That unit would consider whether the request for cancellation had been made in a timely manner and whether the price of the affected trade was outside of the mistrade price range. The Market Supervision staff would immediately send out notices to Members on the Trading System alerting them to the claimed mistrade and to its decision on whether or not to cancel the trade. If the trade then is cancelled, the cancellation is accomplished technically by entering a new trade that is equal and opposite to the original trade. This counter-transaction is published to the market immediately.

Would the Exchange ever "cancel" transactions that resulted from contingent orders set off by cancelled transactions? If so, please describe the Exchange's procedures for handling such situations.

The Market Supervision staff will cancel trades based on contingent orders that have been set off by cancelled transactions where the transaction is executed at a price outside of the mistrade range. Contingent orders set off by a cancelled trade at prices within the mistrade range would not be cancelled.

24. Rule 409 addresses volatility interruption. Please describe how such an event would be denoted on the trade register and other computer records documenting trading activity. Please describe the "price range" that would be cause to determine whether a volatility interruption has occurred.

See the answer to question 17 above for a description of the Volatility Interruption procedure. The trade register would reflect a clear break in time between the last traded price and the price at which trading "re-

opened." The first price when trading resumed would be identified by the Trading System with the "Opening Price" identifier.

25. Pursuant to Rule 413, Exemptions from Position Limits, the Exchange has authority to impose "limitations or conditions on the exemption." The Exchange's decision "shall be final." Please describe the guidance or standards the Exchange would use in limiting or conditioning speculative limits exemptions.

See response to question 26, *infra*.

US Exchange, in imposing limitations or conditions on an exemption from US Exchange's speculative position limits, will use those standards first articulated by the Commission in promulgating former Commission Rule 1.61. Specifically, the Commission advised exchanges that in granting requests for exemption, the amount of the exemption granted from an exchange-set speculative position limit was dependent upon both the nature of the applicant's positions (whether for hedge or risk-management purposes) and whether such positions can be established and liquidated in an orderly manner and in accordance with sound commercial practices.

26. Rule 413 provides for exemptions from position limits, but does not specify application procedures or the types of exemptions allowed. The Regulatory Services Agreement with NFA (p. 10) has a "Hedge Exemption Applications" deliverable, but it is conditional upon the Exchange requesting it. Please explain what types of exemptions from the speculative position limits (e.g., hedging and spreading) the Exchange contemplates granting and why these are not specified in Rule 413. Please describe the procedures for applying for exemptions, and should these procedures be included in the Exchange's rules? Who will be responsible for granting the exemptions, and how will the level be determined? If NFA oversees the exemptions and the Exchange intends to grant exemptions for spreading as well as hedging, the Regulatory Services Agreement at page 10 should be written more broadly to include exemptions other than hedge exemptions.

US Exchange intends initially to list for trading contracts on underlying commodities for which position accountability procedures are applicable. If and when US Exchange were to list for trading contracts for which speculative position limits would be appropriate, it will file with the Commission the US Exchange rule establishing the level of such a speculative position limit as well as the exemptions (hedge, spreading or risk management) and the method for obtaining such exemptions which may be applicable thereto. For example, spread exemptions may be provided for explicitly in a speculative position limit rule, rather than through an application procedure, such as under 17 CFR §150.3(a)(3). Hedge exemptions, however, under 17 CFR 150.5(d)(2), have been required to be granted by application on a case-by-case basis.

The procedures for applying for an exemption would be consistent with those provided under former Rule 1.61. Members desiring an exemption would be required to request an exemption prior to exceeding the US Exchange speculative position limit or shortly thereafter. The application would require the Member to request a specific amount for exemption and to demonstrate the Member's need for positions exceeding the speculative position limit up to the level of the requested exemption.

US Exchange will decide at a later time whether its Compliance staff will determine whether to grant applications for exemptions from speculative position limits or, under its contract with NFA, to request that NFA undertake that role. If US Exchange were to list for trading a contract where an application for exemption other than Hedge Exemptions were to be required, it will make appropriate modifications to the Regulatory Services Contract at that time.

27. Rule 415, Block Trading Facility, states that a minimum size will be specified for Contracts authorized by the Exchange for block trades. Please describe how that minimum size will be determined. In addition, please provide any restrictions that would be imposed with respect to how the price for the block trade may be established.

Generally, in determining the appropriate size of a block order US Exchange will consider the average size of transactions in the underlying cash markets, on its futures markets, and on other futures markets.

Exchange Rule 415 requires that the price of the block must be within a pre-specified price range--between the day's high and low for the contract.

28. Please provide a more detailed description of the procedures and operation of the Vola Trading Facility described in Rule 418, particularly with respect to the entry of OTC options.

The OTC Vola Trade enables Members to enter futures trades negotiated outside the system, whereas the number of future contracts entered corresponds to the delta hedge required for a specific option trade rounded down to the nearest whole integer. Members can enter these futures trades as OTC trades via the new OTC Vola Trade Entry functionality – no matter whether the underlying options trade is an on-exchange or an OTC block trade. Based on the underlying options trade, which can be identified via the Option Trade Transaction, ID, a portion or the whole quantity can be hedged. Delta hedging of option strategies is thereby possible by selecting an appropriate part of one leg of the option strategy.

When entering the OTC Vola Trade,

- **the chosen futures price must be within the daily high/low of the trading day at the time of trade entry.**

- **there are no restrictions concerning the minimum quantity, as the size of the futures hedge is determined by the number of contracts selected from the chosen options trade as well as the delta factor of the option.**

- **Options trades serving as the basis for an OTC Vola Trade entry in the underlying future must have been fully executed between the counterparts of the OTC Vola Trade. Options trades with a third party involved in the execution are not eligible for an OTC Vola Trade entry.**

- **the overall quantity of all Vola Trades using the same Option Trade Transaction ID must not exceed the quantity of the original option trade.**

After successful entry, a transaction number is generated by the system. To complete the OTC Vola Trade, the counter-party of the option trade must retrieve the trade using the transaction number provided by the system to the initiator of the Vola Trade, and approve it. Requests that are not approved will be deleted during batch processing of the day of entry.

The OTC Vola Trade can be deleted by the party entering the trade assuming it has not been approved yet.

OTC Vola Trades can be inquired via the Online Times and Sales Sheet with the trade type "V", distinguishing OTC Vola Trades from other trades on windows and reports.

29. Rules 415-417 each imposes recordkeeping requirements on members. Should these rules, as well as Rule 418, Volatility (Vola) Trading Facility – Exchange of Futures for Options, specifically require that such records be retained pursuant to Commission Regulation 1.31, i.e., for five years and for two years in an accessible place?

Rule 308(a) requires that Members comply with Commission Rules, including Rule 1.31.

30. Rule 601, Investigations, does not include a required time criterion for the completion of an investigation. Please address the time period that the Exchange would consider to be acceptable for a timely investigation.

Because the degree of complexity may vary between various cases, US Exchange has not specified a time criterion for the completion of every

investigation. However, it anticipates that NFA generally will complete investigations within 120 days unless there are extenuating circumstances.

31. Rule 804(d) specifies that the Board and the Commission shall be notified of any exercise of emergency authority, but does not specify the manner in which the Commission would be notified. Please describe how such notification would occur.

Notification will be provided to the Commission staff at its Washington, D.C. headquarters by telephone, electronic mail, fax, or an equally expeditious form of communication. Such notice shall in the first instance be provided to the Director of the Division of Market Oversight or to the Director of the Division of Clearing and Intermediary Oversight, as appropriate to the circumstances, or to their designees. Written notice will thereafter be sent to the Commission at its Washington, D.C. headquarters. Notice to US Exchange Board will be made by any one of the aforementioned methods of communication.

<u>Membership Agreement</u>

1. Paragraph 4.3, Member Front End Installation. Will a member be able to be logged in on more than one computer at a time? If so, please describe how the Exchange will be able to identify the source of an order. Will the Exchange be able to identify the specific computer from which an order was entered? Will the Exchange be able to identify the trader who entered the order?

A trader may have multiple logins and it is therefore possible to login on a workstation several times, or for a trader to login on different workstations, even on workstations in different MISS groups. The trader ID is stored and sent in every single request to US Exchange, however. The Trading System captures and associates with each order sent to US Exchange an identifier for each individual workstation through which an order can be entered, in addition to the trader ID. Accordingly, it is possible to identify the workstation from which the request came and the individual trader who initialized the request.

<u>Preliminary SRO Services Agreement</u>

1. Section 9.11of the Bylaws, Restrictions on Trading and Disclosure by Employees, restricts trading activity and disclosure of information by exchange employees or consultants**.** Please discuss whether the Regulatory Services Agreement should specifically state use and access restrictions as well.

There is no need for the Regulatory Services Agreement specifically to state use and access restrictions applicable to NFA employees. NFA has a Code of Professional Conduct applicable to all employees and which applies to the conduct of all of their official duties, including those performed under the Regulatory Services Agreement. The code prohibits NFA officers and employees from engaging in certain conduct, including the following: (1) Acquiring or retaining any direct or indirect financial interest in a futures account, leverage account or similar account (excluding a stock option account), or margin account unless approved by NFA's president or general counsel; (2) using or disclosing confidential, non-public information obtained in the course of employment.

2. Please discuss whether the agreement should specifically allow the NFA to release trade data to the Commission. Also, should the agreement specifically allow the NFA to release investigation findings to the Commission, either directly or through the Exchange?

The Regulatory Services Agreement does not prohibit NFA from releasing trade data to the Commission. If US Exchange determines that it is more efficient, NFA will provide the audit trail data to the Commission directly.

The Regulatory Services Agreement also does not prohibit NFA from releasing investigative findings to the Commission. However, because under section 5c(b)(2) of the Act, US Exchange remains responsible for these contracted SRO functions, the Commission should first request these findings from US Exchange.

The Regulatory Services Contract need not specifically allow for the release of these documents. Commission Rule 1.31 mandates that all books and records required to be kept under the Act or Commission regulations be kept open to inspection by the Commission and a copy provided upon request by the Commission.

3. Please describe how the Exchange's real-time surveillance would be coordinated with the Exchange Compliance Department's oversight of the daily market surveillance conducted by NFA. The Regulatory Services Agreement obligates NFA to provide, on a monthly basis, reports detailing the number and type of exception reports generated and the number and status of investigations. The agreement states that NFA will provide, on a weekly basis, reports on expiring futures and option contracts including assessments of deliverable supplies, orderly liquidation, and large trader position concentration. Please discuss whether and why weekly and monthly reports are sufficiently timely. Please address whether daily awareness of market surveillance activity would be more useful to the Exchange in coordination with its real-time surveillance.

US Exchange's Market Supervision staff will notify NFA staff of any trading activity that they observe that may assist NFA in carrying out its contractual duties. This coordination may be done either directly or with the assistance of the Chief of the Compliance Department. Likewise, NFA will notify Market Supervision of any activities or events that would assist Market Supervision staff in the discharge of its duties.

The reports that NFA will provide to US Exchange Compliance Department are summary reports in nature and are in addition to, rather than in lieu of, on-going communication between the NFA and US Exchange Compliance Department. Indeed, the requirement for a weekly surveillance report, new to NFA's operations as a provider of regulatory services, is intended to establish continuity of oversight and understanding of market surveillance and is a useful tool in making market surveillance an ongoing rather than an episodic focus of management attention. In this regard, it is directly patterned after Commission practice. Similarly, monthly reports with respect to the number of exceptions generated by NFA's electronic trade practice surveillance system and case load are more frequent than NFA has provided to other markets. The relative frequency of these summary reports does not suggest that more frequent communication is not anticipated by the parties to the contract. Indeed, Schedule A, Section IV F. of the Regulatory Services Agreement provides for weekly consultation between NFA and the Chief of US Exchange's Compliance Department to discuss new inquires and investigations and to provide a general update relating to the status of continuing inquiries and investigations. Again, the monthly summary report is intended to be a management tool so that issues of the timeliness of completion of investigations can be ascertained on a regular basis.

Trade practice and market surveillance is conducted by NFA on a T+1 (trade date + next business day) basis. Any market problems noted by NFA will be discussed with US Exchange personnel daily. It should be noted that all investigations are discussed with US Exchange Compliance personnel prior to completion of any investigative reports. The monthly reports are intended to simply serve as a summary of activity noted during a given period of time, not first notice to US Exchange of potential problems.

4. NFA agreement Schedule (A) VIII Reporting and Recordkeeping states that NFA will maintain all records created in conjunction with Exchange Regulatory Services for a period specified by Commission Regulation 1.31. However, NFA further states that Audit Trail data shall be kept readily available for a minimum of one year and offsite for four additional years. Commission Regulation 1.31 requires that records be kept for a minimum of five years and readily available for inspection for two years. Please discuss this apparent inconsistency.

All trade data will be maintained in accordance with Commission regulations. NFA will keep the audit trail data immediately available online for 13-25 months and offsite storage for a total of 5 years, which is readily accessible within 24 hours upon request.

Market Supervision Trading Business Procedures

1. Page 8, paragraph 2), and page 10, paragraph 2) state that an MS FEX staff member checks if daily valid orders have been entered into the system exactly. Please describe how these checks will be accomplished.

During the Pre-opening period Market Supervision staff checks whether certain orders in the system are valid. Members may enter market orders near the end of the previous day's Trading Period in an attempt to have their order execute at the close. If they enter the order after the trading period has ended, the order will not have been executed, but rather remains in the Trading System for execution during the following day.

As a non-obligatory service to Members, the Market Supervision staff reviews all orders in the Order Book which were entered near the time of the previous day's close. Staff contacts Members directly to ask whether the Member intended for the order to be executed during the previous day's trading period and to alert the Member that the order remains active. The Member has an opportunity at this time (during the Pre-opening phase) to withdraw orders. Accordingly, having been alerted to the status of their orders, Members may choose to withdraw such orders.

General Questions and Comments

1. Please provide the status of all testing efforts accomplished, underway, and planned that are related to the trading system and its interfaces to other systems (e.g., NFA, TCC, Eurex Frankfurt (for disaster recovery)). Of particular interest and value are error-tracking and resolution reports that are associated with the tests. For testing completed, the final version of those reports should be submitted. For testing underway and planned tests, the most recent report and regular (e.g., weekly) updates should be submitted. The submissions should include an explanation of the severity and/or priority ratings assigned to the errors and your threshold for requiring that errors be completed before system launch.

Product and regression tests for US Exchange System are completed. Product Test consists of three different areas: functional test, technical test, end-to-end test with all interfaces. Product Test phase

for all areas ended on September 30, 2003, as planned. All test conditions for all three areas have been executed, charts contain executed test conditions over time per area:

All errors found during test executions have been fixed, test conditions have been retested, Product Test success-rate reached 100% after third execution of cycles; charts contain successfully executed test conditions over time per area:

[redacted]

2. Please provide suggested alternate dates for Commission technical staff to conduct an on-site review of the two Chicago data centers. The review will be focused on physical security, environmental controls, and operational procedures, including market supervision. Please suggest an appropriate time-frame for accomplishing that visit (# of hours required) and a point in time in which most, if not all, facilities and services will be operational.

> **Commission staff are welcome to visit our Chicago data center during the week of November 3, or anytime thereafter during the review period. During that visit, Commission staff can inspect the operation of the current trading platform in production, which is highly similar to US Exchange trading platform. This visit would also include inspection of the nearly completed new co-location data center, from where half of US Exchange back end systems cluster will be operated. In addition, Commission staff can inspect the network access points in Chicago currently in production. Expect the visit to require 4 to 6 hours.**

You are also welcome for follow-up visits at any time during simulation which will begin on December 1st.. The Market Supervision front end environment in its permanent location in Chicago is currently under construction and will be available for a site visit during the week of January 26th, 2004.

3. Please provide suggested alternate dates for Commission staff reviewing the designation application to conduct an on-site review. The review will be focused on the interface between the Exchange and NFA and the Clearing Corporation and especially on the ability of NFA's computerized surveillance system to detect potential violations of trading rules.

Commission staff are welcome to visit during the week of November 3 or anytime thereafter during the review period. We would be happy to coordinate an exact date with NFA and The Clearing Corporation (CCorp). Until simulation trading begins, NFA will be able to conduct a demonstration using stored transaction information. The transfer of trades to CCorp from US Exchange will be identical to the main interface currently in production. Together with CCorp, we would also be happy to acquaint Commission staff with the interface from CCorp to NFA.

You are also welcome for follow-up visits during simulation, best during the week of December 15th, 2003. Alternatively, we suggest the week of January 12th, 2004, during the general Member simulation, when the system would show significant numbers of trading transactions that could be reviewed with the NFA tools. The dates above are tentative and will have to be coordinated with CCorp and NFA.

4. Please describe how the Exchange would comply with Appendix B to Part 38 of the Commission's Regulations which provides, under Core Principle 7, paragraph (a), that "Procedures should also include providing information on listing new products, rule amendments or other changes to previously disclosed information to the Commission, market participants and the public."

US Exchange will post on its website and/or provide written notice to its Members of the listing of new products or changes to its rules or bylaws. Such information shall also be provided promptly to the Commission in accordance with applicable law.

5. In the proposal, comments are made as to the "right of the exchange" to record conversations. Will conversations be recorded? For how long will such recordings be retained?

Yes. US Exchange will retain such conversations for a period consistent with Commission Rule 1.31.

<u>Technical/Typographical:</u>

The noted corrections will be made.