

December 11, 2003

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW.
Washington, DC 20581

Reference File #2379.02
Request for Commission Rule Approval

Dear Ms. Webb:

- 40.5 (i) The following Request for Commission Rule Approval is submitted by the Chicago Board of Trade (CBOT[®]) pursuant to Section 5c(c) of the Commodity Exchange Act and Commission Regulation 40.5. This filing supersedes a previous CBOT submission dated October 30, 2003 (CBOT Reference File #2379.01). That earlier submission hereby is withdrawn.
- 40.5 (ii) Amend Regulations 350.04, 331.01, 350.11 and 350.05(e) as indicated in the attached texts (Additions underlined; deletions struck through).
- 40.5 (iii) The Board of Directors approved these regulation changes pursuant to the CBOT Charter, Article Seventh and the CBOT Bylaws, Article I, Section 2. The CBOT intends to implement these amendments shortly after Commission approval.
- 40.5 (iv) The referenced regulation changes are designed to provide for more efficient resolution of floor broker errors. Cash adjustments tend to be viewed by FCM representatives as a problem because of the inefficiencies of processing adjustment checks, particularly when such checks are related to orders that have been executed on behalf of multiple accounts and/or given up to other firms. The revisions would allow a floor broker, *after specified types of execution errors*, to guarantee the customer a fill at the price to which the customer was entitled via an assignment trade, and thus allow the broker to incur the cost of the “adjustment” through a transaction for his error account rather than by the allocation of a cash adjustment to the customer.

Regulation 350.04, which governs assignment trades, presently permits assignments only when an order has been executed in the market in accordance with its terms and there is a resulting bonafide outtrade. The proposed amendments expand Regulation 350.04 to allow for the assignment not only of outrades, but also of other types of broker errors, including unfilled orders, underfilled orders and wrong price executions. The regulation would continue to require, however, that transactions executed at a more favorable price to the customer be allocated to the customer.

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Attachment 1 provides examples to illustrate how the proposed regulation changes would operate in various broker error scenarios.

40.5 (v) There were no substantive opposing views.

40.5 (vi) The CBOT has not identified any Commission regulations or sections of the Act which require interpretation or amendment in connection with this proposal.

Any questions in this regard may be directed to Dean Payton, Vice President, OIA, telephone (312)435-3658.

Sincerely,

Paul J. Draths
Vice President and Secretary

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Proposed Amendments to Regulations

350.04 Outtrades and Errors and Mishandling of Orders

A. Outtrades - If a floor broker discovers, either intraday or interday, that all or some portion of a customer order was executed but cannot be cleared, the broker shall do one of the following:

1. Re-execute the order in the market and adjust the customer by check if the re-execution price is worse than the original execution price. If the re-execution price is better than the original execution price, the customer is entitled to the better price.
2. Assign the opposite side of the portion that cannot be cleared to his or her error account and assign a fill to the customer at the execution price. The floor broker shall not liquidate the assigned position until at least ten minutes have elapsed after the execution of the order giving rise to the outtrade and, in any event, after the bracket period in which the outtrade arose has ended. These liquidation restrictions shall not apply to a liquidation during a Modified Closing Call. Any profits resulting from the liquidation of the assigned position belong to the floor broker, and may be retained or disbursed to whomever he chooses, in his discretion. ~~A floor broker may not use the assignment process to clear unfilled or underfilled orders, orders that were erroneously executed in the wrong contract month, strike price, put vs. call or side of the market, or price outtrades.~~

~~**B. Errors and Mishandling of Orders**— If a broker fails to execute an order in accordance with its instructions, or underbuys or undersells on an order, and the order, or the remainder of the order, is subsequently filled at a better price, then the customer is entitled to the better price. The customer is also entitled to an adjustment if he incurs a loss because of the delay in execution. However, if a broker overbuys or oversells on an order, the customer is not entitled to any of the excess. A position that has been established in an erroneous or mishandled attempt to execute a customer order must be placed in the error account of the broker or firm responsible for the error or mishandling. When an order has been executed in the wrong contract month or strike price, and the erroneous transaction has been placed in the broker's or firm's error account, the error may be corrected by a spread transaction, in accordance with Regulation 352.01. Any profits resulting from the liquidation of the trades placed in a broker's or firm's error account belong to the relevant broker or firm, and may be retained or disbursed to whomever they choose at their discretion.~~

B. Unfilled or Underfilled Orders – If a broker fails to execute an order or underbuys or undersells on an order, the broker shall do one of the following:

1. Execute the order or the remainder of the order in the market and adjust the customer by check if the customer is filled at a price less favorable than that to which he was entitled but for the error or mishandling. If the order is filled at a more favorable price, the customer is entitled to the better price.

2. Execute the order or the remainder of the order in the market. If the order, or the remainder of the order, is filled at a worse price than that to which it was entitled but for the error or mishandling, the broker may allocate the fill to his error account and assign the opposite side of the order to his error account at the price to which the customer was entitled. If the order is filled at a more favorable price, the customer is entitled to the better price.

C. Wrong Month or Wrong Strike Executions

When an order has been executed in the wrong contract month or strike price and the erroneous transaction has been placed in the broker's or firm's error account, the error may be corrected by one of the following:

1. Execution of the order in accordance with its terms, with an adjustment by check if the order is executed at a worse price as a result of the mishandling of the order.
2. Execution of a spread transaction, in accordance with Regulation 352.01, whereby one leg of the spread represents the correct execution of the order and the other leg offsets the erroneous position in the error account.

D. Wrong Side of Market Executions

When an order has been executed on the wrong side of the market and the erroneous execution has been placed in the broker's or firm's error account, the error may be corrected as follows:

Execution of the order in accordance with its terms, with an adjustment by check if the order is executed at a worse price as a result of the mishandling of the order.

If a broker overbuys or oversells on an order, the customer is not entitled to any of the excess. A position that has been established in an erroneous or mishandled attempt to execute a customer order must be placed in the error account of the broker or firm responsible for the error or mishandling. Any profits resulting from the liquidation of the trades placed in a broker's or firm's error account belong to the relevant broker or firm, and may be retained or disbursed to whomever they choose at their discretion.

In accordance with Regulation 336.01, no broker shall guarantee, directly or indirectly, the execution of an order, or any of its terms, except in the case of a bonafide error or mishandling.

331.01 Price of Execution Binding – The price at which ~~an~~ a transaction order for commodities is executed on the Exchange shall be binding, ~~notwithstanding the fact that an erroneous report in respect thereto may have been rendered.~~ A member shall not guarantee the price of execution to any customer, but a floor broker's or clearing firm's error in the handling of a customer order may be resolved by a monetary adjustment or in accordance with Regulation 350.04.

350.11 Resolution of Outtrades – Outtrades shall be resolved in accordance with Regulation 350.04 or by issuing a check in an amount agreed to by the members making the trade(s).

A. Price Outtrades

When an outtrade exists due to a discrepancy as to price, members making the trade may choose to resolve the discrepancy by electing either of the two prices in question, if they agree that the trade was executed at that price.

If an outtrade involves a price discrepancy between a local and a broker, and the members cannot agree on the price of execution, the price recorded by the broker shall be used to clear the trade. ~~Any adjustments shall then be made by check in compliance with this Regulation.~~

If an outtrade between locals or an outtrade between brokers involves a price discrepancy, and these members cannot agree on the price of execution, the buyer's price shall be used to clear the trade. ~~Any adjustments shall then be made by check, in compliance with this Regulation.~~

B. Quantity Outtrades

When an outtrade exists due to a discrepancy as to quantity, members making the trade may choose to resolve the discrepancy by electing either of the two quantities in question, if they agree that the trade was executed in that quantity.

If any outtrade between locals involves a quantity discrepancy and these members cannot agree on the quantity that was executed, the higher quantity shall be used to clear the trade. ~~Any adjustments shall then be made by check, in compliance with this Regulation.~~

A broker may assign the opposite side of any excess quantity on his order, which he believes that he has executed, to his error account, pursuant to Regulation 350.04, and he may agree to the clearing of the transaction according to the quantity recorded by the other member, whether the other member was a broker or a local.

350.05 Floor Practices (in part) - The following acts are detrimental to the welfare of the Association:

(e) for a member to take, directly or indirectly, the other side of any order of another person revealed to him by reason of his relationship to such other person, except with such other person's prior consent and in conformity with Exchange rules or except for transactions done in accordance with Regulation 350.04 to resolve bonafide errors or outrades;

Attachment 1

Examples:

Assuming the proposed regulation amendments were approved, the broker would have the discretion to resolve the error using either of the methods referenced in the examples below; that is, the assignment would be optional rather than obligatory.

Scenario 1: Underfilled Order

A broker has an order to sell 50 at 105.16 and erroneously fills only 15 at 105.16. The broker sells the 35-lot balance at 105.14.

Current Regulation: The broker must allocate the 35 at .14 to the customer order and issue an adjustment check of 70 tics to the customer.

Proposed Regulation: The broker allocates the 35 at .14 to his error account and assigns the 35-lot balance of the order to his error account at .16, thus incurring the loss of the 70 tics in his error account.

Notes: If the broker filled the 35-lot balance at .16 or better, the fill would be required to be allocated to the customer.

Scenario 2: Unfilled Order

A broker receives an order to sell 50 at the market, however because of a miscommunication with his clerk he fails to execute the order at the time it is executable. But for the error, the order could have been executed at .16. Upon discovery of the order, the broker sells 50 at .14.

Current Regulation: The broker must allocate the 50 at .14 to the customer order and issue an adjustment check of 100 tics to the customer.

Proposed Regulation: The broker allocates the 50 at .14 to his error account and assigns the 50-lot order to his error account at .16, thus incurring the loss of the 100 tics in his error account.

Notes: If the broker filled the 50-lot at .16 or better, the fill would be required to be allocated to the customer.

Scenario 3: Erroneous Confirmation

A broker receives an order to sell 50 at the market. He believes that he filled 50 at 105.16 and that fill is confirmed to the desk. Subsequently, the broker learns that there has been a price outrade and he in fact filled the order opposite the opposing broker at 105.15.

Current Regulation: The broker must allocate the 50 at .15 to the customer order and may, but is not obligated to, issue an adjustment check of 50 tics to the customer because of the erroneous confirmation.

Proposed Regulation: The broker may allocate the 50 at .15 to his error account and assign the 50-lot order to his error account at .16, thus incurring the loss of the 50 tics in his error account.

Scenario 4: Wrong Month or Wrong Strike Execution

No changes to current regulation.

A broker receives an order to sell 50 March at the market and erroneously sells 50 May at 5.60. The March was trading 5.61 at the time.

Current Regulation: The broker allocates the 50 May to his error account and executes a March/May spread such that the May leg offsets the error and the March leg fills the order. The leg prices corresponding to the differential spread are priced such that the customer leg is priced at 5.61, the fill to which the order was entitled. Profits or losses on the May trades belong to the broker.

Scenario 5: Wrong Side of Market Execution

No changes to current regulation.

A broker receives an order to sell 50 at 5.60 and erroneously buys 50 at 5.60.

Current Regulation: The broker allocates the purchase at 5.60 to his error account and fills the sale in the open market. If the sale is filled worse than 5.60, the broker issues an adjustment for the difference; if the sale is filled better, the order receives the benefit of the better fill.