CHICAGO MERCANTILE EXCHANGE INC.

Clearing House Advisory Notice

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TO: Clearing Member Firms
Attention: Operations Managers, Back-Office Managers, Margin Managers

FROM: Clearing House Department

SUBJECT: **Clearing Choices for CME Firms for OneChicago Security Futures**

Introduction

OneChicago (ONE), a new contract market for trading **security futures** – futures on single stocks and futures on narrow-based equity indexes – will begin operations later this year. OneChicago is a joint venture of the Chicago Mercantile Exchange (CME), the Chicago Board Options Exchange (CBOE), and the Chicago Board of Trade (CBOT).

This memo provides a high-level overview of various subjects related to OneChicago and outlines the choices that we will be providing for CME member firms in how trade processing and clearing will be done for OneChicago products.

Clearing and Trade Management – Overview

Participants in OneChicago may be member firms of CME, CBOE or CBOT, or any combination of the three exchanges.

In this document, the term "CME firm" means a CME clearing firm, or other firm number used by a CME clearing firm for the purpose of managing trades. Similarly, the term "CBOE firm" means a member firm of CBOE.

A firm which can trade at both CME and CBOE will be able to execute their OneChicago trades **either** as a CME firm or a CBOE firm. This choice determines how the firm will perform trade management functions. CME firms trading OneChicago products will do **trade management functions** such as giveups using existing CME systems, exactly as they do for CME products.

At launch, OneChicago is providing its participants with a choice of where to clear their trades. A CME firm may choose to **clear** its trades in OneChicago products **either** through the CME **or**, if it is a clearing member of or has a clearing relationship at the Options Clearing Corporation (OCC), through OCC. After the first anniversary of the launch, however, any CME firm that is a clearing member of OCC, or is the affiliate of an OCC clearing member, will be required to clear their trades in OneChicago products at OCC unless a special exception is obtained.

CME firms and trade management functions

CME firms will perform trade management functions for OneChicago trades using the same CME systems used for CME products:

- Firms will receive standard TREX electronic-trade routing messages for OneChicago products, sent to the same queues as the messages for CME products.

- Firms will be able to inquire on their OneChicago trades using the CME's Electronic Trade Posting (ETP) system, as well as to modify certain trade fields such as origin and CTI code.

- Firms will be able to do give-up processing using the CME's standard GUS system.

Trades in OneChicago products will appear as standard CME trades, with the exception that the **Trade ID Source Field** on the TREX message will contain the value **ONE**, to identify the trade as being for a OneChicago product.

Block Trades

Block trades will be reported by the traders to OneChicago's Help Desk and will subsequently be treated in trade management systems like any other trade.

CME firms will receive TREX messages for OneChicago block trades exactly as if they were regular electronic trades, except that a special order type will be designated to identify the trade as a block trade. CME firms will be able to inquire on their OneChicago block trades via the Electronic Trade Posting system and process give-ups for them using GUS.

Give-up Processing

Give-ups may be effected between two CME firms, two CBOE firms, or between a CME firm and a CBOE firm. In other words, firms will be able to do **cross-exchange give-ups**.

Currently, trades which are executed at CBOE may be transferred from the executing broker to the carrying broker, like a futures give-up, pursuant to a Clearing Member Transfer Agreement, instead of a give-up agreement. Therefore such transfers at CBOE and other securities exchanges are referred to as "**CMTA'**s" and are processed differently in certain key respects than give-ups at CME.

Specifically, the CMTA requires no explicit acceptance of an allocation. If firm A transfers a trade to firm B, and the OCC records indicate that a CMTA is in place between firm A and firm B, then the transfer occurs in accordance with the CMTA. If no CMTA agreement is in place, then the trade clears at OCC with the clearing firm normally associated with firm A.

In other words, the transfer of the CBOE transaction is automatically accepted if a CMTA exists, and the trade clears with the executing firm only if no CMTA exists between the two firms. By contrast, at CME, a give-up trade will clear with the original executing firm unless the give-up is explicitly and specifically accepted by the carrying firm.

Given these differences in current business practices, CME and CBOE have agreed on the following protocol to support cross-exchange give-ups of OneChicago products between CME and CBOE firms,:

- Pairs of CME and CBOE firms wishing to do cross-exchange give-ups for OneChicago products will need to register their cross-exchange give-up agreements for this purpose with CME.

- If a cross-exchange give-up agreement exists between a CME firm and a CBOE firm, the clearing firm will automatically accept the give-up from the executing firm. In contrast with a standard CME futures give-up, no specific acceptance is required for a cross-exchange give-up.

The foregoing protocol applies **only** to cross-exchange give-ups. For give-ups of trades in OneChicago products between two CME firms – *i.e.,* two firms using CME for post-trade processing -- existing CME business practices will apply. If the carrying firm has defined the appropriate auto-acceptance rule in GUS, then the give-up will be automatically accepted, but if not, then the carrying firm will be able to specifically accept or reject each give-up trade.

Initial limitations on give-up processing

Because of the complexities involved in creating a real-time link between CME and CBOE systems, the following limitations will apply to give-up processing for OneChicago products at the time of launch:

- Any allocations not accepted by the normal 7:00 p.m. cut-off time will be purged from the system. They will not be carried over to the following business day as unaccepted allocations for CME products currently are.

- Neither GUS "memo adds" nor give-ups of give-ups will be allowed for OneChicago products.

- CME's Average Pricing System (APS) will not be available for OneChicago products.

Comparison of clearing at CME versus clearing at OCC

As indicated above, at least for the first year of OneChicago's operation, CME firms may elect to clear their OneChicago trades at either CME or OCC.

Clearing at CME:

For CME firms electing to clear their OneChicago trades at CME, clearing processing will be done essentially as if the trade involved a CME product:

- OneChicago trades will be booked to the same position account as CME trades and will appear on the same Trade Register report and in the same Trade Register data file as CME trades.
- Firms will submit PCS for their positions in OneChicago products exactly as they submit PCS for CME products, and in the same transmission.
- If necessary, firms will submit next-day position adjustments for OneChicago products exactly as they do for CME products.
- Positions in OneChicago products will be margined using SPAN® together with positions in CME products.
- Settlement variation from positions in OneChicago products will be added together with variation from CME products and banked normally.

OCC has advised CME that OCC will normally have only a single end-of-day settlement cycle for OneChicago products. Although CME has a regular intraday settlement cycle, CME may elect not to bank settlement variation obligations from OneChicago products intraday.

Clearing at OCC:

CME firms electing to clear their OneChicago trades at OCC will use CME's Electronic Trade Posting system to review their OneChicago trades, receive TREX messages for their OneChicago trades from CME, and use the CME GUS system for handling give-ups.

In other words, they will use CME systems for trade management functions exactly as if they were clearing at CME.

The difference lies with clearing functions related to positions, margins and settlements, for which such firms will interface with OCC. Because OCC will handle all aspects of collateral management, settlement processing and banking for these positions:

- These positions will not be on their normal CME Trade Register Report and Datafile;
- Firms will not submit PCS for these positions; and
- CME will not compute margin for these positions.

OCC has advised CME that firms should seek further information on clearing reports and services from OCC.

Open-Close indicators for firms choosing to clear at OCC

OCC does not use CME's PCS (Position Change Submission) method for determining end-of-day position quantities.

Rather, OCC clearing firms may do either or both of the following: (a) ensure that valid open-close indicators are present on trades, and/or (b) submit end-of-day gross position adjustment transactions. Open-close indicators designate whether a particular trade is opening (creating a new position or increasing an existing one) or closing (liquidating an existing position).

CME systems will be enhanced in several respects so that CME firms choosing to clear their OneChicago trades at OCC will be able to specify open-close indicators:

- Open-Close indicators present when the order is submitted, will be present on the trade when it is received from the OneChicago match engine.
- For each trade, the Electronic Trade Posting system will store the value received in the Open-Close Indicator field. Firms may use this system to view this field and/or to change its value.
- The Open-Close indicator will be present on the TREX message to the firm.

Market-Maker Origin

CME firms choosing to clear their trades at OCC will be able to have a separate **Market Maker (MM)** origin. This will be designated by the **numeric digit 6** in the origin code field.

Physical delivery

OCC and its member firms will facilitate physical delivery for CME firms electing to clear their OneChicago trades at CME.

CME firms choosing to clear their OneChicago trades at CME, and which are not already OCC clearing firms, will need to execute a **Third Party Delivery Agreement** with an OCC clearing firm (either an affiliate or an independent third party.) The physical delivery for that CME firm will be accomplished through that specified OCC clearing firm.

OCC and the specified firm will then effect the delivery through NSCC/DTC exactly as if the trades giving rise to the deliverable position had been cleared through OCC.

Customer-level performance bond requirements for positions in OneChicago futures

OneChicago products will be included in CME's daily SPAN files like any other CME product. These files allow CME member firms to calculate performance bond requirements for their individual customer accounts, as well as providing end-of-day settlement prices.

The details of customer-level margining for security futures have not yet been published in final form. CME anticipates, however, that firms which have implemented SPAN in their customer bookkeeping systems will not need to make programming changes.

In other words, SPAN rates and rules will be set, and will be provided in the SPAN file, so that firms will be able to calculate customer-level performance bond requirements for portfolios including OneChicago products, without modifying their existing bookkeeping systems.

OneChicago stock futures and two-byte product codes

Until recently, product ("commodity") codes for all CME products required only two bytes. Although most CME systems have long supported larger product codes, in most cases CME has refrained from forcing firms to make programming changes associated with switching to an expanded product code.

For example, CME has published SPAN files since 1999 in an XML-based format in which product codes may assume any length, but have continued to publish SPAN files in the original "packed" and "unpacked" formats which support only two-byte codes and which have been used since 1988. The majority of CME clearing firms still use the original formats.

As described above, a typical OneChicago ticker symbol will be **MSFT1C** – **MSFT** identifying the company, **1** identifying the "primary" symbol, and **C** identifying OneChicago.

So that OneChicago can be launched without at this time forcing programming changes associated with expanding the product code field, CME clearing system codes for OneChicago products will be defined as two-byte, "TCC format", codes.

TREX trade messages, the Trade Register Datafile, the PCS file, the Settlement Price File, and the existing "packed" and "unpacked" format SPAN files will all use these two byte TCC codes. The CME will publish both reports and a machine-readable datafile which can be used to cross-reference the 6-byte ticker symbol with the 2-byte TCC clearing code.

We will also begin publishing the daily SPAN files in the "expanded-unpacked" format. This format is similar to the standard packed and unpacked formats, but supports product codes up to 10 bytes long. In this format, and also in the XML-based format, product codes will be provided as the OneChicago symbol.

Cross-exchange give-ups and 3-digit firm numbers

Until now CME systems have not required the 3-digit firm number to be qualified by the exchange of that firm. A good example of this is the GUS system.

If CME firm 002 is giving up a trade to CBOE firm 003, this means that the GUS system does not currently support the designation of the target firm as **CBOE** firm 003 – just as firm 003. In addition, a CME firm 003 may already exist.

To allow CME firms to give up OneChicago futures trades to CBOE firms and to receive give-ups in these products from CBOE firms, each CBOE firm will be assigned a unique firm number for use in the GUS system, as follows:

- If the CBOE firm number is not already used at CME, the firm number for use in GUS will be assigned as the CBOE firm number.
- If the CBOE firm number is already used at CME, the firm number for use in GUS will be assigned as another available number.

CME will publish reports allowing CBOE firms to be cross-referenced to the firm numbers to be used in GUS.

For more information

In the near future, OneChicago and/or CME will publish additional advisories covering:

- Processing for **Corporate Events** such as stock splits
- Information regarding **Fees and Billing** for OneChicago products
- Information regarding **Trading of OneChicago products**

For more information regarding OneChicago and its products, see the OneChicago web site at www.onechicago.com.

For information regarding **Regulatory aspects** of OneChicago products, see **Advisory #NP-0184** published by the **Intermarket Surveillance Group** on May 22, 2002, and available on the CME web site at http://www.cme.com/allaire/spectra/system/securemediastore/NP0184a.pdf.

Specifying your clearing choices

To assist in the preparations for the launch of OneChicago and to help make the pre-launch testing more realistic, we are asking each CME clearing member firm to submit a **OneChicago Processing Selection Questionnaire**. This form will allow you to indicate your plans, to the extent they are already known, regarding:

- whether you will clear your OneChicago trades at CME or OCC
- if you are clearing at OCC, the OCC firm number through which you will clear
- if you are clearing at CME, the OCC firm number through which you will do your deliveries.

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