



CHICAGO MERCANTILE EXCHANGE INC.

AUDIT AND MARKET REGULATION INFORMATION BULLETIN

TO: Members
Chief Financial Officers
Chief Compliance Officers

FROM: Audit Department, Clearing House Division
Market Regulation Department, Legal and Regulatory Division

DATE: September 12, 2003

SUBJECT: Clearing Fees & Proprietary Trading Requirements - **REMINDER**

CME rules require that proprietary trading be conducted by bona-fide employees. Recently, several issues have been raised regarding the “employee” requirement for proprietary trading qualifying for preferential clearing fees. Such concerns extend to proprietary trading conducted by clearing members, in-active clearing members, and Rule 106.H., I., and N. members.

Our marketplace, both the trading environment and customer base, has evolved and expanded over the years. We have seen a tremendous growth in interest from proprietary trading groups to trade our markets electronically. With these changes, we believe it is beneficial to reiterate and solidify our requirements for proprietary trading entitled to preferential clearing fees.

In order to receive preferential clearing fees, proprietary trading must be conducted within the division of membership held and meet all of the following requirements:

Only bona-fide employees and owners (identified in the firm’s operating agreement) of the firm may conduct the proprietary trading activity. Bona-fide employees are evidenced through:

- Issuance of a W-2 for **all** compensation to the trader;
- Inclusion in the firm’s payroll tax records; and
- The trader has no income until the firm pays the trader.

The proprietary account is 100% owned by the firm. A proprietary account is evidenced through:

- Only the firm’s capital is at risk of loss - no traders may have their own capital at risk;
- All profits and losses of the account are written off to income;
- All profits and losses of the account are taxed to the firm; and
- The trader does not make any capital contribution to the account.

Trades executed by individual owners in a clearing member firm for the firm's proprietary account may receive member rates on those trades as long as all of the owners' trading results are aggregated before any profit distributions are made. In this way, all of the owners share in the trading risks of the other owners.

Trades executed by owners in a clearing member firm who wish to have their trading results segregated from the trading results of other owners may receive member rates on those trades if they contribute and maintain at least \$500,000 to the firm. This contribution must represent bonafide capital in the firm, subject to all of the firm's operating risks.

There are two exceptions to the above requirements. First, independent contractors and other self-employed individuals on a Rule 106.F. Employee Transfer may trade the proprietary account of a clearing member or in-active clearing member and receive equity member clearing fee rates. Second, proprietary trading activity conducted by commodity trading advisors registered with the National Futures Association may receive equity member clearing fee rates.

Recently it has come to our attention that independent contractors and other self-employed individuals are frequently trading the proprietary accounts of our members. Similar to employees, these individuals generally are compensated based on performance (percentage of profits) and have no responsibility for loss in the account. However, as an independent contractor, a trader is compensated through a Form 1099 and may receive favorable capital gains tax treatment. Thus, the trader receives a benefit of membership.

In order to clearly and accurately establish the account as a proprietary account of the member (versus a joint account), the proprietary trading must be conducted by employees of the firm, except as noted above. Keep in mind that a member trader and member firm may have a joint account and receive preferential clearing fee rates on contracts under the lowest division of membership held.

To further clarify GLOBEX® and Open Outcry Exchange clearing fee policies regarding proprietary trading:

GLOBEX

Clearing fees are charged on contracts traded through GLOBEX based on the membership status of the operator and account owner except when the operator is an employee of a clearing member firm. In such case, when a clearing member employee is the terminal operator, the clearing fees are only based on the membership status of the account owner. The employee must be issued a W-2 and be included on the firm's payroll records.

Thus, all proprietary trading activity conducted within the division of membership held on GLOBEX by a clearing member employee is entitled to preferential clearing fees. Once again, the employee must be issued a W-2 and included on the firm's payroll records as detailed above.

For example, a clearing member's proprietary trading activity conducted by an employee (issued a W-2 and included on the firm's payroll records) through GLOBEX will receive equity member clearing fee rates. However, a clearing member's proprietary trading activity

conducted by an independent contractor through GLOBEX will receive clearing fee rates based on the membership status of the operator/independent contractor – most likely customer clearing fee rates.

Open Outcry

The proprietary trading of a clearing member is entitled to equity member rates on all contracts when an employee owning a membership conducts it on the floor of the Exchange. All proprietary trading activity conducted on the Exchange floor by an Rule 106.F. Employee Transfer member is entitled to equity member clearing fees regardless if the Rule 106.F. member is an employee or not of the clearing member. Finally, the proprietary trading of a clearing member conducted with discretion by a Rule 106.D. Futures Industry Transfer (Lessee) on the floor will be charged Rule 106.D. lessee clearing fees regardless if the Rule 106.D. lessee is a clearing member employee or not.

Penalties

The policies set forth herein will be strictly enforced by the Exchange. A member or clearing member found to have engaged in fraudulent or dishonest conduct or to have acted in bad faith will be subject to a charge of a major rule violation. Major rule violations are punishable by a fine up to \$1,000,000 plus the monetary value of any benefit received as a result of the violative activity.

If you have any questions, please contact the Audit Department at (312) 930-3230 or e-mail us at audits@cme.com or the Market Regulation Department at (312) 930-8525 or e-mail us at marketregulation@cme.com.