



20 South Wacker Drive  
Chicago, IL 60606-7499  
www.cme.com

312/930.1000 *tel*  
312/466.4410 *fax*

## Special Executive Report

S-4408

February 14, 2006

### MODIFICATIONS TO RULE 539.C. EFFECTIVE FEBRUARY 19, 2006

On February 13, 2006, the Exchange approved amendments to Rule 539.C. ("Prearranged, Pre-Negotiated and Noncompetitive Trades Prohibited – Pre-Execution Discussions Regarding GLOBEX Trades") that become **effective on Sunday, February 19, 2006**. The amendments are the result of CME implementing a new automated Request for Cross ("RFC") process with respect to CME® Globex® Eurodollar options transactions that result from pre-execution discussions. The change in RFC functionality was made for several reasons. The current RFC process is manual and prone to user error while the new RFC process strikes a balance between the business needs of market makers and brokers. Also, the new RFC process will be transacted in the regular CME Globex order book in keeping with the CME philosophy of centralized liquidity, equal access, and market transparency.

The new process will continue to require market users to submit a Request for Quote ("RFQ") prior to engaging in private discussions with respect to CME Globex Eurodollar options trades. Thereafter, pre-execution discussions that result in two market users agreeing to trade opposite one another will require the brokering party to enter an RFC that will contain both the buy and the sell orders. Upon entering the RFC, CME Globex will broadcast a market data message informing the marketplace that the 15 second Pre-Cross period has begun. During this period, the bid/ask quantity and the price will not be broadcast to the marketplace but other orders for the particular contract or combination of contracts may be entered by other market participants into CME Globex during this period. At the conclusion of the Pre-Cross period, CME Globex will evaluate the order book's regular quantity at price liquidity and will automatically match with either side of the RFC. In the event neither side of the RFC is fully matched, CME Globex will match common remaining RFC bid/ask quantities at a rate of 60%, which is termed the Broker Match Guarantee. After completion of the Pre-Cross period, CME Globex will broadcast a message informing the marketplace that the Cross period has begun. At the conclusion of the Cross period, CME Globex will match 100% of the common RFC quantity and broadcast a message informing the marketplace that the order book is back in a normal trading state.

Please see the Question & Answer section on pages 3 and 4 for greater detail concerning the new RFC functionality. Additionally, CME Market Regulation Regulatory Advisory 06-01 from February 13 provides an overview of the different procedures for conducting pre-execution discussions in CME Globex Eurodollar options versus other CME Globex products.

The enhanced RFC functionality has required several changes to Rule 539.C. ("Prearranged, Pre-Negotiated and Noncompetitive Trades Prohibited – Pre-Execution Discussions Regarding GLOBEX Trades"). The text of the approved amendments appears on the next page with additions underlined and deletions overstruck. If you have any questions concerning the amendments, please contact Kathleen Zaino, Associate Director, Market Regulation, at 312/930.2341 or Tim McDermott, Director and Compliance Counsel, at 312/648.5433.

**539. PREARRANGED, PRE-NEGOTIATED AND NONCOMPETITIVE TRADES PROHIBITED**

[Sections A. and B. are unchanged.]

**539.C. Pre-Execution Discussions Regarding GLOBEX Trades**

Parties may engage in pre-execution discussions with regard to transactions executed on the GLOBEX platform where one party (the first party) wishes to be assured that a contra party (the second party) will take the opposite side of the order under the following circumstances:

1. A party may not engage in pre-execution discussions with other market participants on behalf of another party unless the party for whose benefit the trade is being made has previously consented to permit such discussions.
2. Parties to pre-execution discussions shall not (i) disclose to a non-party the details of such discussions or (ii) enter an order through the GLOBEX platform to take advantage of information conveyed during such discussions except in accordance with this rule.
3. With the exception of orders entered pursuant to the terms of Section C.5. below, Aa period of 5 seconds shall elapse between entry of the two orders in the case of futures orders or a period of 15 seconds shall elapse between entry of the two orders in the case of option orders.
4. With the exception of orders entered pursuant to the terms of Section C.5. below, in any transaction involving pre-execution discussions, the first party's order must be entered into the GLOBEX platform first and the second party's order may not be entered into the GLOBEX platform until the time period prescribed in Section 539.C.3. above has elapsed.
5. In electronic Eurodollar options operated Pursuant to Rule 585 ("GLOBEX® Call Market Trading Algorithm"), solicitation of bid(s) and/or offer(s) between market participants through private discussion for the purpose of establishing a market or improving the market for an eligible contract or an eligible combination of contracts for options on Eurodollar futures shall be preceded by issuing a Request For Quote ("RFQ") through an eligible terminal. Subsequent to such RFQ, a trade intended for execution pursuant to Rule 585 for which there has been a pre-execution discussion shall must be initiated withby the entrance of a Request for Cross ("RFC") Order which will contain both the buy and the sell ordersTrade ("Cross Request") for the specific contract or combination of contracts, with explicit reference to the anticipated order quantity. The order from the initiator of the RFCross Request Orderfor the contract or combination of contracts must be entered within the same trading session as the entry of the RFQthree (3) minutes of the entry of the Cross Request. The opposing order may not be entered until the requisite period of time as stipulated in Section C.3. above has elapsed. Failure to enter the initiatingRFC order within three (3) minutes of same trading session as the entry of the RFQCross Request shall be considered an abandonment of that pre-execution discussion. Any subsequent pre-execution discussion during a subsequent trading sessionconcerning the transaction must be preceded by the entry of a new RFQ and, thereafter, a new Cross Request must be entered before proceeding with the order entries.

## **Questions and Answers**

### **Q1. What constitutes a pre-execution discussion?**

**A1.** A pre-execution discussion is any private conversation or solicitation of an order in which parties disclose any proprietary information about an order to another market participant. Proprietary information would include **SIDE**, **SIZE** or **PRICE** of the order. All CME Eurodollar options orders which involve pre-execution discussions must be executed using the new Request for Cross (RFC) functionality on CME Globex. For a description of the CME Eurodollar Options RFC and how it works, please refer to the Q&A posted at [www.cme.com/files/RFC\\_QA.pdf](http://www.cme.com/files/RFC_QA.pdf).

### **Q2. If I have been a participant in a pre-execution discussion, may I place an order in the pit for that strategy or a similar strategy?**

**A2.** No. Under no circumstances may anyone involved in the pre-execution discussion place any order for pit execution which would take advantage of information disclosed in a pre-execution discussion about a forthcoming or potentially forthcoming order. *This is in direct violation of Rule 539 and may be considered a major offense.*

### **Q3. Does asking for a two-sided market constitute a pre-execution discussion?**

**A3.** No. Asking for a two-sided market would be considered a private discussion, but not a pre-execution discussion. For CME Eurodollar options, *all private discussions must be preceded by the entry of a Request for Quote ("RFQ") on CME Globex.*

### **Q4. During Regular Trading Hours, may I ask the pit for a market and launch an RFQ on CME Globex for the same strategy?**

**A4.** Yes. Asking for a market in both venues is allowed.

### **Q5. During RTH, may I split an order between venues, working partial executions in both the pit and on CME Globex?**

**A5.** Yes, provided that the order has not been disclosed in a pre-execution discussion, you may work the order in both venues. If a pre-execution discussion has taken place, the order may not be worked in the pit.

### **Q6. A client asks a firm for a market in a strategy without giving the firm an order or without any implied or express indication of side, size or price. The firm launches an RFQ and then calls a market maker to solicit a quote. The market maker responds with a two-sided market and tells the firm it can work the order. After the market maker's order is publicly displayed, the initiating client places an order for the strategy. Does the firm have to use the RFC message?**

**A6.** No. If a market maker gives you a two sided market to work AND you immediately put both sides of the order in the pit and/or on CME Globex, then an RFC is not required. However, if

the firm were to withhold either side of the market maker's order from the marketplace and then solicit the client's order, this would constitute a pre-execution discussion which would necessitate the use of the RFC message. As a reminder, in this scenario and in all other situations in which there has been the solicitation of bids and/or offers through private discussions in order to establish or improve a market, such private discussions **MUST** be preceded by the entry of an RFQ.

- Q7. A client places an order with a firm to sell 10,000 June 9500 straddles at 23 or better. The broker at the firm launches an RFQ and the market comes back 23/24, 1,000 up. The broker solicits a market from the pit and gets a 23/24 market, 2,000 up. The broker calls a market maker to try and find enough liquidity to fill the entire order. The broker has not exposed the client's order to either venue. The market maker gives the broker an order to pay 23 for 5,000. How should the broker fill the order?**
- A7.** The broker in this scenario has had a pre-execution discussion with a market maker before disclosing the original order to the marketplace. The broker must fill the orders using the two-sided RFC on CME Globex. In all instances, withholding a client's order while shopping the order among other market participants prior to entering the order into CME Globex will necessitate the use of the RFC message.
- Q8. A client asks a broker for a quote in the June 9500 straddles and after entering the RFQ, the broker calls a market maker who gives a 23/24 market. The client asks the broker whether there are any 23.5 bids. The broker asks the market maker if he is 23.5 bid. Has a pre-execution discussion taken place?**
- A8.** Yes, the broker and the market maker discussed side of the market and price, therefore a pre-execution discussion has taken place.
- Q9. If a client asks a broker for a market and the broker wants to solicit bids/offers away from the central order book by contacting other market participants, must the broker inform the client that the broker plan's to have such private discussions?**
- A9.** Yes, the broker must make the client aware that the broker was working to find liquidity outside of the central order book and the broker must enter the required RFQ prior to having the private discussions.
- Q10. Must a broker obtain a client's consent to engage in pre-execution discussions with other market participants?**
- A10.** Yes. The broker may not engage in pre-execution discussions with respect to any client's order unless the client has previously consented to permit such discussions.

**If you are in doubt** about whether your conversations constitute a pre-execution discussion, it is always safer to enter your customer order into the book prior to contacting other market participants. There is nothing wrong with working an order to try and obtain the best fill for a customer. Violations of the requirements concerning pre-execution discussions occur when you reveal SIDE, SIZE or PRICE to another market participant and subsequently fail to enter the orders by using the new RFC order ticket.