

CFTC Letter No. 02-92**August 2, 2002****No-Action****Division of Clearing and Intermediary Oversight**Re: Certain basis trading involving Eurex and LIFFE futures and options

Dear :

This is in response to your June 7, 2002 letter to Commission staff and related telephone conversations. These communications have concerned the anticipated expansion of products by "R" to include transactions, specifically basis transactions, in certain foreign debt securities executed through the electronic trading platform of its U.K. affiliate, "S". As discussed below, the futures leg of the basis transactions will be executed by "S" on the Eurex Deutschland ("Eurex") and the London International Financial Futures and Options Exchange ("LIFFE"). Based on the facts as represented, you request that the staff grant no-action relief to permit "R" to offer these new products in the U.S.

Background

The facts as represented by you are that "R", a Delaware limited liability company, operates an electronic inter-dealer trading system (the "System") for U.S. Government, Agency and Mortgaged-Backed securities. "R" is registered with the Securities and Exchange Commission ("SEC") as a broker-dealer, a member of the National Association of Securities Dealers ("NASD") and is regulated by NASD Regulation, Inc. ("NASD Reg"). With two exceptions, all of the participants on the System (the "Participants") are banks or broker-dealers registered as such with the SEC.^[1] The Participants include most of the major fixed-income securities dealers in the U.S. "R" commenced operations in June 2000 and is currently one of the leading platforms for the trading of fixed-income securities in the U.S., having traded more than \$24 trillion in notional amount since it commenced operations.

"S", a limited liability company organized under the laws of England and Wales, operates an electronic trading system for Foreign Debt Securities^[2] (the "UK BrokerTec System"). "S" is a category "A" authorized investment firm under the UK Financial Services and Markets Act (the "FSMA") and is regulated by the U.K. Financial Services Authority ("FSA"). Under its current authorizations, "S" is, generally, (i) prohibited from holding client money, (ii) authorized to deal in investments (including futures and options) as principal, and (iii) authorized to deal in investments as agent. All participants on the "W" are market counterparties. "S" also offers basis trading in certain Foreign Debt Securities, specifically U.K. and German sovereign debt. In order to provide this facility, "S" has become a member of LIFFE and Eurex, the European exchanges on which futures contracts on such debt are currently traded.

“R” and “S” are both wholly-owned subsidiaries of “T” and are affiliates of “U”, a designated contract market, and “V”, an approved derivatives clearing organization, both of which are regulated by the Commission.

Expansion of Activities

On April 12, 2002, “R” submitted a request to NASD Reg to modify its Membership Agreement with the NASD to add inter-dealer brokerage of Foreign Debt Securities to the System. “R” intends to use the System to provide substantially the same trading functionality for Foreign Debt Securities as is currently available for transactions through the System in U.S. Government, Agency and Mortgage-Backed securities that settle through the Government Securities Clearing Corporation (“GSCC”), and the Mortgaged-Backed Securities Clearing Corporation (“MBSCC”). Participants would be permitted to post, view and accept bids or offers for specific securities, and orders at the same prices would be automatically matched by the System.

“R” will enter into an agreement with “S”, to act as agent for the purpose of facilitating the execution of all Foreign Debt Securities. Settlement will be between the Participants, or in the majority of the proposed Foreign Debt Securities, a central counterparty. “S” has arrangements with the European clearing houses London Clearing House (“LCH”) and Banque Centrale de Compensation (“ClearNet” and collectively, the “Clearing Corporations”) to allow “S” to send trade details and settlement instructions to the respective Clearing Corporation on behalf of each Participant, its European regulated affiliate or its third party clearer automatically upon execution of a trade. The Clearing Corporations have agreed with their members that they will accept transactions submitted by “S”. For Foreign Debt Securities that cannot at present be settled with a central counterparty, settlement will be direct between the relevant Participants.

All Foreign Debt Securities transactions entered into by the Participants will be settled directly between the counterparties or their agents or with the respective Clearing Corporation and in accordance with its rules. Neither “R” nor “S” will take any position (matched or otherwise) in Foreign Debt Securities.

The Foreign Debt Securities that may be added to the System will include any such securities that may be cleared through the Clearing Corporations. The System will also permit repurchase and reverse repurchase transactions on Foreign Debt Securities.

Participants on the System will execute “R’s” standard Participant Agreement, as well as one or more Supplements governing transactions in the relevant Foreign Debt Securities.

Basis Trading Involving Foreign Debt Securities

“R” expects to offer Participants that are interested in trading U.K. and German sovereign debt securities [\[3\]](#) through the System the ability to engage in basis trading. Basis trading will provide Participants with

a supplementary method to trade Foreign Debt Securities which is ancillary to the proposed trading of Foreign Debt Securities and which will enhance Participants' ability to hedge positions in such securities with a minimum of execution risk.

In a basis trade, a Participant will (i) purchase (or sell) a Foreign Debt Security or a defined group of Foreign Debt Securities (the "Cash Leg") and (ii) simultaneously sell (or purchase) an equivalent number of futures contracts on the same underlying securities (the "Futures Leg") traded on either Eurex or LIFFE. A basis trade will be executed as a single integrated transaction through the System based on bids and offers submitted by Participants with respect to the pricing relationship (or "spread") between the Cash Leg and the Futures Leg. "R" will calculate the cash price required to match the number of futures lots. This calculation is based on the last exchange-traded futures price multiplied by the prevailing conversion factor to produce the applicable cash amount.

The Cash Leg will be submitted to one of the two Clearing Corporations in accordance with the settlement procedures proposed for Foreign Debt Securities executed by Participants through the System, and will be cleared and settled in the same way as any other eligible foreign debt security. The Futures Leg will be executed by "S" via the LIFFE or Eurex remote access systems and given up to the relevant Participants at the executed price. Participants are responsible for accepting trades entered this way and "S" may cancel or unwind unaccepted trades. Each Participant will be required to be, or have engaged the services of, a clearing member on the registered futures exchange for the relevant futures contract, and shall be responsible for reporting the Futures Leg to such futures exchange in accordance with any requirements of such exchange. In addition, each Participant shall be required to be a clearing member of the relevant clearinghouse for the futures contract (LCH in the case of LIFFE, or Eurex Clearing, AG in the case of Eurex) or to designate a "Clearing Agent" that is such a clearing member and that has agreed to be responsible for clearing and settling the Futures Leg on behalf of such Participant. The relevant documentation governing each Participant's Basis trading with "R" will provide that "R" will not be responsible for (i) performance by the parties or any third party of any obligation with respect to the Futures Leg, (ii) monitoring or reporting the settlement of the Futures Leg, or (iii) the credit position of any party.

Basis trading will provide Participants with a service that is ancillary to the existing cash trading that occurs through the System. "R" is not taking on any new types of Participants in connection with basis trading. Moreover, under the terms governing Participants' basis trading, "R" does not assume any additional settlement risk in connection with the execution of basis trades, since the Cash Leg will be subject to the same settlement procedures as cash transactions currently executed through the System, and the Futures Leg will be cleared and settled directly and automatically between the relevant Participants or their agents after the trade is given up. As noted above, "R" has contractual protections to prevent it from being responsible for settlement of the Futures Leg ("S" will use its own clearer, but will reserve the right to call margin to cover its own margin obligations and take an indemnity from Participants for the consequences of their failure to take up the relevant trades).

Discussion

The Division has reviewed and considered your letter and, in particular, has considered the following:

- The foreign markets on which the Futures Leg of the transaction will be executed, Eurex and LIFFE, are operating under no-action letters previously granted by Commission staff to permit those markets, subject to the specified conditions, to access U.S. customers via trading terminals and automated order routing systems.^[4] “S”, the firm that will execute the Futures Leg of the basis trade, is a member of both Eurex and LIFFE and the transactions will be executed subject to the rules of those exchanges.
- The two firms involved in handling the Cash Leg of the basis transactions are registered or recognized in their respective jurisdictions and operate pursuant to and in conformity with the securities laws of these jurisdictions. In this regard, “S” is a category “A” authorized investment firm under the UK Financial Services and Markets Act and is regulated by the U.K. Financial Services Authority and “R” is registered with the Securities and Exchange Commission as a broker-dealer, a member of the National Association of Securities Dealers and is regulated by NASD Regulation, Inc.
- The contemplated expansion of services to include basis trading is ancillary to the existing cash trading that occurs through the system and “R” is not taking on any new types of Participants in connection with basis trading.
- The participants on the System (subject to two exceptions) are banks or broker-dealers registered as such with the SEC. Furthermore, each participant will assume full responsibility for reporting the Futures Leg to the relevant futures exchange and for clearing and settling the Futures Leg with the relevant clearinghouse.

Based on these representations, the Division will not recommend that the Commission institute enforcement action against “S” based solely on its failure to register as an introducing broker pursuant to rule 30.4(b), 17 C.F.R. 30.4(b). Moreover, the Division does not view the activity described above as inconsistent with the provisions of the no-actions previously granted to Eurex and LIFFE. The Division notes, however, that the no-actions previously granted to Eurex and LIFFE and their members generally require orders for U.S. customers to be handled by registered futures commission merchants or firms that are exempt from registration under rule 30.10, 17 C.F.R. 30.10, and that this requirement may be pertinent to the post-execution reporting and clearing arrangements necessitated by this trading activity. This no-action position does not excuse “S” from complying with any other applicable provision of the Act or of the Commission’s regulations.

This no-action position is taken by the Division only and does not necessarily reflect the views of the Commission or any other unit or member of the Commission’s staff. It is based upon the information and representations contained in your June 7, 2002 letter or otherwise communicated to the Commission by you. Any materially different, changed, or omitted facts or circumstances may render this letter void. This letter will cease to be effective if the Commission or its staff adopts generally applicable rules or

general guidelines regarding the issues addressed herein, and “R” will be subject to those rules or guidelines in that event.

If you have any questions concerning this correspondence, please contact Andrew Chapin, an attorney on my staff, at 202-418-5430.

Very truly yours,

Jane Kang Thorpe
Director

^[1] Aside from banks and broker-dealers, the current participants on the “R” platform also include one U. S. Government-sponsored enterprise and the U.S. capital markets affiliate of one of the largest Japanese banks, which is a GSCC Netting Member.

^[2] "Foreign Debt Securities" include the following:

- a) Public debt issued by the Governments of: Austria, Belgium, Finland, France, Germany, Greece, Italy, Ireland, The Netherlands, Portugal, Spain, and United Kingdom,
- b) Euro-denominated Euro Denominated Sovereign, Supra-Sovereign 8 Agency Debt Issued by: Canada, Italy, Sweden, United Kingdom, European Investment Bank, Federal Home Loans Mortgage Corporation (FREDDIE MAC), Kredit fuer Wiederaufbau, Deutsche PostBank AG, Dexia Municipal Agency, State of North Rhein Westphalia, and
- c) Euro-denominated fixed income securities issued by regional German Banks with the benefit of municipal or state guarantee (Pfandbriefe).

^[3] Sovereign debt securities of the U.K. and Germany have been designated by the SEC as exempted securities under SEC rule 3a-12, thereby allowing futures and options thereon to be offered and sold in the U.S.

^[4] See CFTC Staff Letter No. 99-48, [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶27,917 (CFTC Division of Trading and Markets, August 10, 1999) (Eurex Deutschland); CFTC Staff Letter No. 99-31, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,744 (CFTC Division of Trading and Markets, July 23, 1999) (LIFFE).