U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5260
Facsimile: (202) 418-5527
www.cftc.gov

Division of
Market Oversight

CFTC letter No. 06-07
March 22, 2006
No-Action
Division of Market Oversight

Ms. Stephanie Ford
Vice-President, Legal/Compliance
HedgeStreet, Inc.
1825 South Grant Street, Ste. 500
San Mateo, CA 94402

RE: Request for No-Action Relief from Commission Rule 15.03(b)

Dear Ms. Ford:

This is in response to your letter dated January 24, 2006 on behalf of HedgeStreet, Inc. (HedgeStreet or Exchange), a designated contract market and registered derivatives clearing organization. In that letter you request no-action relief from certain large trader reporting requirements that are triggered by the contract reporting levels of Commission rule 15.03(b).[1] The market and large trader reporting rules (reporting rules) are contained in parts 15 through 21 of the Commission's regulations.[2] The reporting rules are implemented by the Commission partly pursuant to the authority of sections 4a, 4c(b), 4g, and 4i of the Commodity Exchange Act (Act).[3] Collectively, the reporting rules are structured to ensure that the Commission receives adequate information to carry out its market and financial surveillance programs.[4]

We understand the facts to be as follows. Commission rule 15.03(b) establishes contract reporting levels for commodity futures and option contracts. Commission rule 15.03(b) applies a contract reporting level of 125,000 to all HedgeStreet Products. The term HedgeStreet Product,

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[1] 17 CFR 15.03(b).

[2] 17 CFR parts 15 to 21.

[3] 7 U.S.C. 1 et seq.

[4] The market surveillance programs analyze market information to detect and prevent market disruptions and enforce speculative position limits. The financial surveillance programs combine market information with financial data to assess the financial risks presented by large customer positions to Commission registrants and clearing organizations. See 69 FR 76392 (December 21, 2004).

however, is strictly defined by Commission rule 15.03(a) as a HedgeStreet contract that has a maximum possible return of $10 if in the money upon expiration.[5]

Since its inception, HedgeStreet has listed for trading exclusively self-cleared and fully collateralized contracts that have a maximum possible return of $10 if in the money upon expiration. Exclusively self-cleared contracts are contracts for which no persons, other than a designated contract market and its clearing organization, are permitted to accept any money, securities, or property (or extend credit in lieu thereof) to margin, guarantee, or secure any trade.[6] Presently all contracts listed by HedgeStreet are exclusively self-cleared and fully collateralized.[7] Pursuant to recent certified Exchange rule filings, HedgeStreet has listed for trading exclusively self-cleared and fully collateralized contracts with variable returns that can exceed $10 per contract (referred to herein as $10-plus contracts).[8] For example, HedgeStreet has listed a $10-plus contract on natural gas that has a maximum possible return of $40 per contract, and a $10-plus contract on gold that has a maximum possible return of $50 per contract.

As a result of the strict regulatory definition of HedgeStreet Products, the Commission set contract reporting level of 125,000 is not applicable to any $10-plus contract. Instead, such contracts are subject to the reporting levels codified in rule 15.03(b) for specific commodities. If no such reporting level is applicable to a particular $10-plus contract, then that contract is subject to the default reporting level of 25 contracts set for futures and option contracts that are derivatives of all other commodities.[9]

In your letter, you request that the Division of Market Oversight (Division) grant HedgeStreet no-action relief from adhering to the contract reporting levels that are otherwise applicable to HedgeStreet's $10-plus contracts. You propose that the Exchange be permitted to

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[5] 17 CFR 15.03(a).

[6] See Proposed Commission rule 15.00(f), 70 FR 74246, 74254 (December 15, 2005). The Commission has proposed rules that would require designated contract markets listing exclusively self-cleared contracts to file large trader reports with the Commission on behalf of the contract's traders. See id at 74249.

[7] A condition of designation requires HedgeStreet to comply with the reporting requirements of part 17 of the Commission's regulations on behalf of all traders of exclusively self-cleared contracts. See HedgeStreet Inc., Amended Order of Designation as a Contract Market (HedgeStreet's Amended Order of Designation), paragraph A.1 (December 5, 2005)(on file with the Commission), available at www.cftc.gov/dea/deahedgestreet_submissions_comments.htm.

[8] See HedgeStreet Rule Submissions (December 29, 2005)(on file with the Commission). In December of 2005, the Commission amended HedgeStreet's Order of Designation to permit the Exchange to offer larger sized contracts that could be cleared by members of The Clearing Corporation. See HedgeStreet's Amended Order of Designation, paragraph B. The scope of this no-action letter, however, is limited to contracts that are exclusively self-cleared.

[9] For example, since no reporting level for contracts based on an index of real estate prices is enumerated in Commission rule 15.03(b), a HedgeStreet NAR real estate $10-plus contract would be subject to the default reporting level of 25 contracts.

adhere instead to reporting levels that are determined through the application of a maximum return formula. The proposed maximum return formula first establishes $1,250,000, the maximum monetary value associated with a reportable position in a HedgeStreet Product, as a baseline value. This baseline value is the product of $10, the maximum possible return of a HedgeStreet Product, and 125,000 contracts, the number of contracts that would render positions in a HedgeStreet Product reportable. The proposed maximum return formula then divides $1,250,000 by the maximum possible return of a particular $10-plus contract to arrive at a specific reporting level for that contract.

Under this proposed approach, the reporting level for a $40 maximum return contract, such as the Exchange's natural gas $10-plus contract, would be 31,250 contracts. This reporting level is arrived at by dividing $1,250,000, the maximum monetary value associated with a reportable position in a HedgeStreet Product, by $40, the natural gas $10-plus contract's maximum possible return. Similarly, under the proposed approach, the reporting level for a $50 maximum return contract, such as the Exchange's gold $10-plus contract, would be 25,000 contracts. This reporting level is arrived at by dividing $1,250,000, the maximum monetary value associated with a reportable position in a HedgeStreet Product, by $50, the gold $10-plus contract's maximum possible return. For any $10-plus contract, the proposed maximum return formula would render positions on HedgeStreet reportable when such positions could represent a maximum monetary value of $1,250,000.

The Division generally believes that the application of the contract reporting levels codified in Commission rule 15.03(b) to HedgeStreet's $10-plus contracts is unlikely to assist the Commission in conducting meaningful market and financial surveillance. For example, Commission rule 15.03(b) applies a contract reporting level of 200 contracts to commodity futures and option contracts based on natural gas. In the absence of relief, HedgeStreet's natural gas $10-plus contract would be subject to the contract reporting level of 200. The reporting level of 200 contracts for natural gas, however, has typically been applied to contracts that have characteristics, such as significantly higher notional values, that are different from the contracts presently offered by HedgeStreet. The NYMEX Henry Hub Natural Gas futures contract, for example, has a notional value of approximately $71,820.[10] The notional value associated with a reportable position of 200 contracts in the NYMEX Henry Hub Natural Gas futures contract is approximately $14,364,000.[11] In comparison, HedgeStreet's natural gas $10-plus contract has a maximum value of $40 per contract. The notional value associated with a reportable position of 200 contracts in HedgeStreet's natural gas $10-plus contract is $8,000.[12]

In light of the foregoing, the Division considers the application of the contract reporting levels codified in Commission rule 15.03(b), in the absence of relief, to HedgeStreet's $10-plus contracts, to be unnecessary for conducting meaningful market and financial surveillance. Consequently, the Division will not recommend any enforcement action against HedgeStreet, or

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[10] This figure is arrived at by multiplying 10,000 mmBtu by $7.182, the February 17, 2006 settlement price of the March 2006 NYMEX Henry Hub Natural Gas futures contract.

[11] This value is arrived at by multiplying 200 contracts by $71,820.

[12] This value is arrived at by multiplying 200 contracts by $40.

persons trading on HedgeStreet, to the Commission, under sections 4a, 4c(b), 4g, or 4i of the Act for violations of part 15, or parts 17 through 19, of the Commission's regulations, or for violations of paragraph A.1 of HedgeStreet's Amended Order of Designation.

This no-action relief is limited to violations that may arise from the failure to apply the contract reporting levels codified by the Commission in rule 15.03(b) to otherwise reportable positions in $10-plus contracts. This no-action position is contingent upon the full compliance of HedgeStreet, and persons trading on HedgeStreet, with all regulatory obligations arising from contract reporting levels that are determined through the application of the maximum return formula, as referenced in this letter, to specific $10-plus contracts. To effectuate full compliance, all persons relying on the Division's issuance of no-action relief shall consider such contract reporting levels to be quantities specified in Commission rule 15.03(b). In addition, the Commission may, subsequent to the issuance of this letter, codify contract reporting levels for HedgeStreet's $10-plus contracts. HedgeStreet, and all persons trading on HedgeStreet, must adhere to any codified contract reporting level for $10-plus contracts.

This no-action position should not be construed in any way as the Division's endorsement of a formulaic approach to structuring contract reporting levels, including a formulaic approach based on the notional value of specific contracts. The analysis of notional value presented in this letter is meant to emphasize certain differences between HedgeStreet's $10-plus contracts and larger sized contracts that are typically listed by other designated contract markets. In recommending contract reporting levels to the Commission, the Division may consider factors other than notional value, including such factors as the expected and actual level of trading in specific contracts, or the particular characteristics of market participants, when assessing the surveillance utility of various contract reporting levels.

This no-action position is taken by the Division and does not necessarily reflect the views of the Commission or any other division or member of the Commission's staff. Because this position is based upon facts and representations contained in this letter, any different, omitted or changed facts or conditions might require a different conclusion. This no-action position remains contingent on the continued compliance of HedgeStreet with all applicable obligations under the Act and regulatory conditions imposed by the Commission. If you have any questions regarding this correspondence, please contact David P. Van Wagner at (202) 418-5481 or Bruce Fekrat at (202) 418-5578.

Sincerely,

Richard A. Shilts
Director