Understanding the EFRP Market for Stock Index Futures

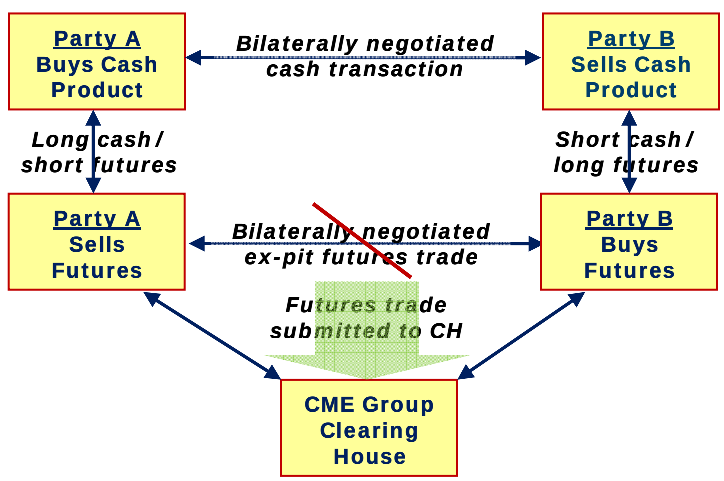
Exchange for Physical (EFPs) transactions originated over a century ago in grain and other physical commodity markets. Over the years, the practice has been adopted in the context of financial futures and generalized as "Exchange of Futures for Related Positions" (EFRPs). This document is intended to explain EFRPs as they are currently practiced in CME Group stock index futures markets.

What is an EFP? – An EFP is a transaction that is privately negotiated between two counterparties and involves the simultaneous exchange of a futures position for an economically offsetting cash, spot or OTC position. In addition to EFPs, both CME and CBOT Rulebooks (see CME and CBOT Rule 538) permit Exchange for Risk (EFR) transactions. EFRs are distinguished from EFPs insofar as the position that offsets the futures contract is an (OTC) instrument such as a swap. Apart from this distinction, EFPs and EFRs are almost identical, representing two forms of Exchange of Futures for Related Position (EFRPs) transactions.

EFRPs essentially may be thought of as privately negotiated "basis trades." The futures trade is bilaterally negotiated apart from a competitive trading environment such as the CME Globex electronic trading platform or the Exchange floor and subsequently novated to the CME Group Clearing House where it is accounted for just like any other futures position. Note that CME Group plays no role in facilitating the execution of, or subsequent bookkeeping for, the cash position. Rather, that is contingent upon the two counterparties to the EFP.

Ex-Pit Transactions – The term "ex-pit" refers to any transaction that is executed on a non-competitive basis. EFPs and EFRs represent two types of EFRPs … which in turn represent a subset of a larger group of "ex-pit" transactions including block trades (see CME and CBOT Rule 526); Substitution of Futures for Forwards (SUB) trades (see CME Rule 537); and, back-office transfers (see CME and CBOT Rule 853). A block trade is an ex-pit or privately negotiated futures transaction which, unlike an EFRP, does not involve an offsetting cash or OTC transaction. A SUB is a transaction whereby a previously executed OTC transaction may be novated to the CME Group Clearing House (CH) and, in the process, is converted into an equivalent futures position. While there are some regulatory distinctions, all these trades represent non-competitively negotiated transactions which are referred to in the aggregate as "ex-pit" transactions.

EFRP Transaction



Offsetting Cash Position – The cash, spot or OTC position that is traded opposite to the futures contract in the context of an EFRP must be a product that represents a legitimate economic offset. The Exchange identifies acceptable offsets for any particular listed market in an FAQ published by the CME Group Market Regulation Department. In the context of stock index futures, recognized offsetting positions include (i) baskets of stock; (ii) Exchange Traded Funds (ETFs); or, (iii) OTC equity swaps.

Stock baskets must be "highly correlated" to the underlying index with a correlation of 0.90 or greater to be part of an EFP. Further, these stock baskets must represent at least 50% of the underlying index by weight; or, include at least 50% of the names of the underlying index. The notional value of the basket must be functionally equivalent to the value of the futures component of the trade.

Exchange Traded Funds ("ETFs") are also acceptable as part of an EFP provided that they mirror stock index futures traded on the Exchange. For example, SPDRs represent an acceptable mirror for S&P 500 futures insofar as the SPDR Trust holds the stocks that constitute the Index in a (near) exact match. Likewise, QQQQs represent an acceptable mirror for Nasdaq-100 futures.

Equity swaps that mirror stock index futures are likewise acceptable as a component of an EFRP transaction.

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***How to Transact?* –** An EFRP may be transacted at any time and at any price agreed upon by the two counterparties. Two customers may transact an EFRP amongst themselves provided that the resulting futures position is subsequently submitted to the CME Group Clearing House through the facilities of a Clearing Member. More commonly, however, a customer establishes a relationship with a dealer who is inclined to make a market, *i.e.,* show a bid and an offer, in the particular market(s) in question. These dealers will normally require that the customer carries a futures account as well as a securities account in which the resulting futures and cash positions may reside. There are a variety of firms which may make markets in EFRPs although the Exchange assumes a neutral posture and does not offer recommendations in this regard.

After the two counterparties consummate the transaction, the futures position is reported to the CH through a Clearing Member via the EFP Trade Entry System (TES). The cash position continues to be held in appropriate accounts established by the EFP counterparties and is not reported to the Exchange upon execution. If called upon during the course of a periodic audit, however, Clearing Members may be required to produce statements that evidence that the offsetting position was transacted and meets Exchange standards as a valid offsetting position.

While dealers often show bids and offers on EFRPs to customers directly, the Exchange does not post such quotes or otherwise facilitate the execution of these transactions. CME Group cannot facilitate the transaction of stock index EFRPs where the cash side of the transaction represents a basket of securities or ETFs. In particular, one must be registered as a securities exchange to facilitate the public trade of securities under U.S. law, noting that CME Group operates as a registered futures exchange and not as a securities exchange.

Proportion of EFRPs to Total Volume

	2007			2008		
	Volume	EFRPs	%	Volume	EFRPs	%
E-Mini S&P 500	415,348,228	501,089	0.12%	633,889,466	576,513	0.09%
S&P 500	15,837,593	909,316	5.74%	16,250,201	1,527,896	9.40%
E-Mini Nasdaq-100	95,309,053	79,828	0.08%	108,734,456	51,826	0.05%
Nasdaq-100	1,683,378	216,759	12.88%	1,330,713	209,758	15.76%
Mini $5 DJIA	40,098,882	604	0.00%	55,348,312	8,617	0.02%
E-mini S&P MidCap	7,352,427	9,383	0.13%	8,580,467	11,401	0.13%
MSCI EAFE	172,371	1,605	0.93%	450,138	813	0.18%
MSCI EM	26,793	0	0.00%	171,987	0	0.00%

Who Trades EFPs and Why? – EFRPs are generally utilized by institutional traders who find themselves with existing cash positions which they may wish to offset using futures transactions. For example, a market maker in ETFs may find themselves either long or short large inventories which they may wish to hedge. By utilizing an EFRP transaction, these market makers may readily transform a pre-existing ETF position into a futures position, thereby enjoying the liquidity and financial sureties associated with trading at CME Group. So-called "program traders" who seek to arbitrage possible temporary pricing discrepancies between cash and futures markets may find EFRPs to be a convenient way to liquidate or reduce possible long or short stock basket holdings.

***Value of Transparent Pricing* –** Ex-pit transactions including EFRPs are allowed by CME Group as an accommodation to traders who find this a convenient and expeditious way of conducting business. They are not intended to represent the mainstream way of trading futures. Rather, the Exchange expects that the plurality of trading shall be conducted in an open, competitive trading venue such as open outcry or on Globex.

Price discovery represents a primary function of the futures market. Thus, it is important to promote a transparent trading venue as the primary trading venue where values may readily be referenced. Liquidity is a necessary prerequisite for the efficient discovery of equilibrium prices. Thus, it is not our intention to divert any significant volume of trade from the mainstream competitive marketplace. In fact, only a small proportion of volume in major stock index futures is transacted as EFRPs as indicated in the accompanying table.

Still, EFRPs represent a useful and convenient outlet for some traders and, therefore, remain consistent with the Exchange's mission of providing customers with an efficient source of price discovery as well as hedging utility. - *John Labuszewski, Brett Vietmeier & Lucy Wang*