

# SECURITIES AND EXCHANGE COMMISSION

## SECURITIES EXCHANGE ACT OF 1934

Release No. 70148 / August 8, 2013

### Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Eurex Deutschland

#### I. Introduction

The United States Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest to issue this Report of Investigation (“Report”) pursuant to Section 21(a) of the Securities Exchange Act<sup>1</sup> (“Exchange Act”) to highlight the risks that exchanges and investment professionals undertake when they operate without the appropriate compliance measures in place to monitor the composition of indices on which financial instruments are offered to ensure that they are in compliance with the federal securities laws. Exchanges and investment professionals should take the appropriate steps to verify that they are in compliance with the federal securities laws, which could include establishing policies and procedures to appropriately monitor the composition of indices on which futures are based to determine if they are offering security futures products. This Report also serves to highlight analogous situations involving swaps, and reminds investment professionals who engage in swap transactions of their responsibility to ascertain the characteristics of such swaps to ensure that, for those that are securities, the investment professional is appropriately offering the securities to persons in the United States, and otherwise complying with all applicable federal securities law requirements.

Eurex, a foreign derivatives exchange headquartered in Frankfurt, Germany, self-reported to the Commission and Commodity Futures Trading Commission (“CFTC”) staff that it had been offering and selling contracts to persons in the U.S. on a non-narrow based index that had shifted to security futures on a narrow-based security index for approximately 18 months without complying with the applicable registration requirements prescribed by the federal securities laws.<sup>2</sup> The Division of Enforcement has investigated whether Eurex violated the federal securities laws by effecting transactions in the U.S. in security futures contracts that were not listed on a national securities exchange or a national securities association, and whether Eurex improperly offered and sold the security futures contracts while there was no registration

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<sup>1</sup> Section 21(a) of the Exchange Act authorizes the Commission to investigate violations of the federal securities laws and, in its discretion, to “publish information concerning any such violations.” Eurex Deutschland (“Eurex”) has consented to the issuance of this Report without admitting or denying any of the statements or conclusions herein. This Report does not constitute an adjudication of any fact or issue addressed herein. In addition, the statements and conclusions in this Report do not represent determinations by the Commission with respect to any persons or entities other than Eurex.

<sup>2</sup> Eurex self-reported the conduct to the Commission and CFTC staff on October 21, 2011 after discovering the issue.

statement in effect or where there was no available exemption from registration under the Securities Act of 1933 (“Securities Act”).<sup>3</sup>

## **II. Facts**

### **A. Structure and Organization of Eurex Deutschland**

Eurex is a derivatives exchange located in Frankfurt, Germany, which lists futures contracts and options on futures based on interest rates, volatility indexes, broad-based security indexes, inflation rates, and commodities. Eurex is operated by Eurex Frankfurt AG and clears its transactions through Eurex Clearing AG, a wholly-owned subsidiary of Eurex Frankfurt AG. Eurex is regulated and subject to market surveillance by German regulatory agencies, including the Exchange Supervisory Authority in the State of Hesse, where Eurex is located, and by the German Federal Financial Supervisory Agency (Bundesanstalt für Finanzdienstleistungsaufsicht) (the “BaFin”).

Eurex operates through an all-electronic trading platform, with members connected to Eurex via a dedicated communications network from hundreds of locations worldwide. Firms located in the United States who are members of Eurex have been able to access Eurex’s trading platform directly from trading terminals in the United States since 1996 with respect to futures and options on futures contracts under conditions set forth by the CFTC.

Eurex membership is offered to financial institutions, financial services institutions and credit institutions across the world, provided certain conditions are met. Eurex does not offer membership to individuals. Persons in the United States may obtain direct market access to Eurex through a U.S. financial institution<sup>4</sup> that is a Eurex member, with respect to futures and options on futures contracts under conditions set forth by the CFTC. Persons in the United States also may send orders to Eurex through international Eurex members who are futures commission merchants (“FCMs”) or exempt from FCM registration.<sup>5</sup>

### **B. The EURO STOXX Banks Index**

Eurex initially offered futures on the EURO STOXX Banks Index (“Index”) for trading on March 19, 2001. On April 2, 2002, the staff of the CFTC issued a no-action letter in connection with Eurex’s request to offer and sell futures on the Index in the U.S. from Eurex

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<sup>3</sup> The Commission notes that, although the registration issues highlighted in this Report relate to Eurex, a foreign exchange, similar issues could arise if a U.S. futures exchange were to offer or sell security futures on a broad-based index that shifted to a narrow-based index.

<sup>4</sup> To the extent a financial institution effected transactions in the United States through Eurex in futures on the EURO STOXX Banks Index once the futures on the Index became a security futures product, the financial institution would have needed to ensure that it was registered with the Commission as a broker-dealer or otherwise could rely on a specific exclusion or exemption from registration.

<sup>5</sup> A futures commission merchant is an individual who, or organization that, solicits or accepts orders to buy or sell futures contracts or options on futures contracts and accepts money or other assets from customers in connection with such orders. An FCM must be registered with the CFTC.

terminals located in the United States,<sup>6</sup> based in part on the fact that Eurex represented that the Index was a broad-based security index.<sup>7</sup>

According to Eurex, as of October 10, 2001, the Index consisted of stocks from 44 issuers in ten European countries, including Italy, Greece, Spain, Germany, Belgium, France, Ireland, Portugal, Austria, and the Netherlands. Eurex represented to the CFTC staff in its request for no-action relief that, as of October 10, 2001, no single stock in the Index represented more than 10.7% of the Index, and the five most heavily weighted stocks in the Index represented 48.3% of the Index. The CFTC staff concluded that the Index complied with the relevant sections of the CEA, including that it was a broad-based security index, and determined that it would not recommend an enforcement action if futures contracts based on the Index were offered or sold in the United States.<sup>8</sup> As a future on a broad-based security index, the future was subject to the exclusive jurisdiction of the CFTC. According to Eurex, from at least April 2, 2002 through October 21, 2011, Eurex offered and sold security futures on the Index in the U.S. through direct market access and other methods.

### **C. Discovery of the Conduct Leading to the Self-Report**

In September 2011, the CFTC adopted new procedures requiring markets with existing CFTC no-action letters to certify that they remained in compliance with the guidance set forth in those no-action letters. In connection with CFTC's new procedures, Eurex conducted a review of the Index and discovered that the Index no longer qualified as a broad-based security index. In fact, Eurex discovered that the Index had not been a broad-based security index for approximately eighteen months.

Eurex's review revealed that the Index first assumed a characteristic that would, but for the statutory tolerance and grace periods, render it a narrow-based security index in January 2010, because the five highest weighted component securities in the Index exceeded 60% of the Index's weighting. Following a three month grace period, the Index transitioned from a broad-based to a narrow-based security index, and futures on the Index became subject to joint CFTC and Commission jurisdiction. Further, futures on the Index became subject to registration and regulatory requirements under the federal securities laws with which Eurex did not comply.<sup>9</sup>

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<sup>6</sup> CFTC Staff Letter No. 02-38 (April 2, 2002).

<sup>7</sup> Section 1a(35) of the Commodity Exchange Act ("CEA") and Section 3(a)(55)(B) of the Exchange Act.

<sup>8</sup> CFTC Staff Letter No. 02-38 (April 2, 2002).

<sup>9</sup> In this regard, the Commission notes that Congress provided in the definition of the term "narrow-based security index" in both the CEA and the Exchange Act for a tolerance period ensuring that, under certain conditions, a futures contract on a security index traded on a designated contract market ("DCM") may continue to trade, even when the index temporarily assumes characteristics that would render it a narrow-based security index under the statutory definition. See CEA section 1a(35)(B)(iii), 7 U.S.C. 1a(35)(B)(iii); section 3(a)(55)(C)(iii) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(iii). In general, an index is subject to this tolerance period, and therefore is not a narrow-based security index, if: (i) a futures contract on the index traded on a DCM for at least 30 days as a futures contract on a broad-based security index before the index assumed the characteristics of a narrow-based security index; and (ii) the index does not retain the characteristics of a narrow-based security index for more than 45 business days over 3 consecutive calendar months. Pursuant to these statutory provisions, if the index becomes

From on or about April 2010 through October 2011, after the Index transitioned to a narrow-based security index, Eurex sold 6 million future contracts worldwide on the Index through approximately 79 foreign-based intermediaries and direct market access trading terminals in the United States. During the same period of time, other orders were facilitated through omnibus customer accounts carried by foreign-based intermediaries on behalf of persons in the U.S. Eurex allowed persons to directly access its market using means or instrumentalities of interstate commerce to effect transactions in security futures through trading terminals located in the U.S. This practice resulted in the sale of approximately 120,000 security futures to persons in the U.S.

Based on its investigation, the staff has determined that Eurex did not comply with the federal securities laws by effecting transactions in the U.S. in security futures: (1) that were not listed on a national securities exchange or national securities association;<sup>10</sup> and (2) without registering as a national securities exchange.<sup>11</sup> In addition, Eurex offered and sold security futures in the U.S without registering the transactions and without having a valid exemption from registration for the transactions as required by Section 5 of the Securities Act.<sup>12</sup>

However, due, in part, to its substantial cooperation and remedial efforts, the Commission is not bringing an enforcement action against Eurex. Eurex self-reported the findings of its review to the Commission and CFTC staff on October 21, 2011, and has been in continuous and close contact with the staff, providing updates and documents on a voluntary basis to the staff. Eurex also obtained additional information from its customers and has been cooperative in providing documents and information to the BaFin for production to the staff.

### **III. The Relevant Provisions of the Federal Securities Laws**

We wish to highlight the relevant provisions of the Exchange Act and Securities Act that were at issue in this investigation. Enforcement actions infrequently involve the application of the Securities Act and Exchange Act to derivative contracts and other less-traditional financial instruments, and an expanded discussion of the relevant provisions in this investigation may assist exchanges and investment professionals in determining whether they are appropriately offering securities to persons in the United States.

#### **A. Section 6(h)(1) of the Exchange Act**

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narrow-based for more than 45 business days over 3 consecutive calendar months, the index is excluded from the definition of the term “narrow-based security index” for the following 3 calendar months as a grace period.

<sup>10</sup> Section 6(h)(1) of the Exchange Act states that “it shall be unlawful for any person to effect transactions in security futures products that are not listed on a national securities exchange or a national securities association registered pursuant to section 15A(a).”

<sup>11</sup> Section 5 of the Exchange Act.

<sup>12</sup> Section 5 of the Securities Act.

Section 6(h)(1) of the Exchange Act prohibits any person from effecting any transaction in security futures products that are not listed on a national securities exchange registered pursuant to Section 6 of the Exchange Act or a national securities association registered pursuant to Section 15A of the Exchange Act. It is important that a security futures product be traded on a national securities exchange pursuant to Section 6(h) of the Exchange Act to ensure that the product meets a national securities exchange's listing standards and that the trading of the product is subject to both such exchange's and the Commission's oversight. Section 3(a)(55)(A) of the Exchange Act defines a security future to mean a contract of sale for future delivery of a single security or of a narrow-based security index, including any interest therein or based on the value thereof, except an exempted security under Section 3(a)(12).

More specifically, Section 3(a)(55)(B) provides that a "narrow-based security index" is an index:

- i. that has 9 or fewer component securities;
- ii. in which a component security comprises no more than 30 percent of the index's weighting;
- iii. in which the five highest weighted component securities in the aggregate comprise more than 60 percent of the index's weighting; or
- iv. in which the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting have an aggregate dollar value of average daily trading volume of less than \$50 million (or in the case of an index with 15 or more component securities, \$30 million), except that if there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting, such securities shall be ranked from lowest to highest dollar value of average daily trading volume and shall be included in the calculation based on their ranking starting with the lowest ranked security.

Based on the information obtained during the investigation, the staff has determined that Eurex did not comply with Section 6(h)(1) of the Exchange Act when Eurex effected transactions in the U.S. in security futures products that were not listed on a national securities exchange or a national securities association. According to Eurex, as of June 2009, the five highest weighted component securities in the Index, in the aggregate, comprised more than 60 percent of the Index's weighting. By April 2010, after the expiration of the applicable tolerance period and grace period, the Index transitioned to a narrow-based security index and futures on

the Index became security futures,<sup>13</sup> subject to registration and regulatory requirements with which Eurex did not comply.<sup>14</sup>

## **B. Section 5 of the Exchange Act**

Section 5 of the Exchange Act makes it unlawful for any broker, dealer, or exchange to effect any transaction in a security, or to report any such transaction, unless such exchange is registered as a national securities exchange under Section 6 of the Exchange Act or is exempted from such registration. Section 3(a)(1) of the Exchange Act defines an “exchange” to mean “any organization, association, or group of persons...which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities....” The Commission has stated that “an exchange or contract market would be required to register under Section 5 of the Exchange Act if it provides direct electronic access to persons located in the U.S.”<sup>15</sup> An entity’s registration as a national securities exchange pursuant to the requirements of Section 5 of the Exchange Act is important because a national securities exchange acts as a self-regulatory organization responsible for overseeing trading on its market and its members’ compliance with applicable statutory and regulatory provisions. Further, as a national securities exchange, it is subject to Commission oversight of, among others, its rules, disciplinary actions, and books and records.

Eurex regularly and consistently offered and sold security futures on the Index in the U.S. through direct market access. Eurex should have registered as a national securities exchange with, or been exempted from such registration by, the Commission before providing direct market access to effect transactions in security futures products on the Index to persons in the U.S. Accordingly, Eurex did not comply with Section 5 of the Exchange Act.

## **C. Section 5 of the Securities Act**

Section 5(a) of the Securities Act provides that, unless a registration statement is in effect as to a security, it is unlawful for any person, directly or indirectly, to engage in the unregistered offer or sale of securities in interstate commerce. Section 5(c) of the Securities Act provides a similar prohibition against offers to sell, or offers to buy, unless a registration statement has been

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<sup>13</sup> As noted in footnote 9 above, the CEA and the Exchange Act provide for a grace period within which a futures contract on a broad-based security index may continue to trade, even when the index temporarily assumes characteristics that would render it a narrow-based security index under the statutory definition. See CEA section 1a(35)(B)(iii), 7 U.S.C. 1a(35)(B)(iii); section 3(a)(55)(C)(iii) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(iii). In this instance, the Index assumed the characteristics of a narrow-based security index in June 2009, and later transitioned to a narrow-based security index after the expiration of the applicable grace period. See id.

<sup>14</sup> Persons effecting transactions in security futures for persons or accounts in the U.S. are required to register with the Commission as a broker-dealer pursuant to the process set forth under Section 15(b) of the Exchange Act. To the extent Eurex or any other person facilitated or effected transactions in security futures for persons or accounts in the U.S., unless an exemption or exclusion were applicable, registration as a broker-dealer would have been required.

<sup>15</sup> Securities Exchange Act Release No. 60194 (June 30, 2009), 74 FR 32200 (July 7, 2009).

filed. Thus, both Sections 5(a) and 5(c) of the Securities Act prohibit the unregistered offer or sale of securities in interstate commerce, unless the offerings are exempt.

The Securities Act includes a statutory exemption in Section 3(a)(14) from all provisions of the Securities Act, other than Section 17(a) anti-fraud provisions, for security futures that are cleared by a U.S.-registered or exempt clearing agency and traded on a national securities exchange.<sup>16</sup> The statutory exemption for security futures was not available for the particular security futures involved because the conditions of the exemption were not met – the security futures were not traded on a national securities exchange and cleared by a U.S.-registered or exempt clearing agency. As a result, Eurex was required to comply with Section 5 of the Securities Act with respect to the offer and sale of the security futures. Based on the information obtained by the staff, Eurex did not comply with Section 5 of the Securities Act. The contracts on the Index were securities from the time the Index transitioned from a broad-based index to a narrow-based index. Eurex offered and sold the securities to customers through means of interstate commerce without registration or a valid exemption from registration.

Because Eurex was not able to rely on the statutory exemption for security futures and did not register the security futures at issue under the Securities Act, certain disclosures under the Securities Act were not available to investors. For example, if Eurex had registered the security futures at issue under the Securities Act, it would have filed a registration statement with the Commission covering the offer and sale of the security futures that would disclose to investors information about the security futures and about the clearing agency that is the issuer of the security futures. Moreover, investors would have been entitled to the protections of Section 11 and Section 12(a)(2) of the Securities Act with respect to the disclosures contained in the registration statement and other offering materials.

#### **IV. Discussion**

The Commission is issuing this Report, and foregoing an enforcement action against Eurex, in part, because of its substantial and timely cooperation and prompt remediation efforts. On October 21, 2011, Eurex self-reported to the Commission and CFTC staff that it had been offering and selling contracts in the U.S. on a non-narrow based index that had shifted to security futures on a narrow-based security index for approximately 18 months without complying with the applicable registration requirements prescribed by the federal securities laws. Immediately on discovering the issue, Eurex ceased offering and selling the security futures on the Index in the United States and sent a notice informing Eurex members of the change in status of the futures on the Index.

Up until the discovery that the Index had become a narrow-based security index, Eurex had no policies and procedures in place to monitor compliance of the futures on its indices with the conditions of the CFTC no-action letter or the requirements of the federal securities laws applicable to security futures. Eurex has since implemented comprehensive policies and procedures that now require monthly, and in some instances daily, compliance monitoring of indices on which it offers futures contracts in the U.S. Specifically, if through monthly

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<sup>16</sup> Section 3(a)(14) of the Securities Act.

monitoring Eurex staff determines that the Index is on the verge of becoming a narrow-based security index, the procedures require that Eurex staff will commence monitoring on a daily basis.<sup>17</sup>

In issuing this Report, we observe that Eurex's failure to comply with the federal securities laws could have been prevented if Eurex had adequate internal controls to ensure compliance with the provisions of the federal securities laws governing security futures. Up until its discovery that the Index had become a narrow-based index, Eurex did not regularly monitor the composition of the Index or otherwise verify that the Index was not a narrow-based security index while it was offering and selling security futures contracts in the U.S. for approximately eighteen months. Exchanges and investment professionals should take the appropriate steps to verify that they are in compliance with the federal securities laws, which could include establishing policies and procedures to appropriately monitor the composition of indices on which futures are based to determine if they are offering security futures products.

In addition, we note that Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act gives the Commission jurisdiction over security-based swaps by including them in the definition of security under the Securities Act and the Exchange Act and the CFTC jurisdiction over swaps (collectively, "Title VII Instruments"). The test for whether an agreement, contract, or transaction is a swap or a security-based swap also uses the definition of narrow-based security index in Section 1a(35) of the CEA and Section 3(a)(55)(B) of the Exchange Act.<sup>18</sup> However, while futures (including security futures) sold in the United States are listed on exchanges where the exchange's requirements often require a review of whether the future is on a single-stock security, narrow-based security index, or broad-based security index, such is not the case with bilaterally negotiated swaps and security-based swaps that are entered into solely with eligible contract participants ("ECPs"). Unlike futures, swaps and security-based swaps may be sold over-the-counter solely with ECPs, where the characteristics must be vetted by the counterparties to the transaction based on the statutory and rule-based definitions of narrow-based security index.<sup>19</sup>

As such, anyone entering into Title VII Instruments based on an index should carefully consider the characteristics of the instrument to determine whether it is a security-based swap. The investment professional will need to make this determination before offering to enter into

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<sup>17</sup> Eurex's newly-implemented policy for monitoring an index's status states monitoring shall switch from a "monthly" to a "daily" basis if any index: (1) has 10 component securities; (2) has a component security that comprises more than 25% of the index's weighting; (3) has five highest weighted component securities that in the aggregate comprise more than 55% of the index's weighting; or (4) has the lowest weighted component securities comprising, in the aggregate, 25% of the index's weighting that has an aggregate dollar value of average daily trading volume of less than \$55,000,000 (or in the case of an index with 15 or more component securities, \$35,000,000).

<sup>18</sup> See Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement;" Mixed Swaps; Security-Based Swap Agreement Recordkeeping, Exchange Act Release No. 67453 (July 18, 2012), 77 Fed. Reg. 48208 (Aug. 13, 2012).

<sup>19</sup> Where there is an offer and sale to a non-ECP of a security-based swap, the transaction must be registered under the Securities Act and traded on a national securities exchange.

the transaction in order to determine whether the federal securities laws apply. Failure to do so could put a party at risk of violating Section 5 of the Securities Act for offering and selling securities in unregistered transactions without a valid exemption, or other applicable provisions of the Exchange Act relating to security-based swaps.

## **V. Conclusion**

When offering financial instruments based on indices, exchanges and investment professionals should take the appropriate steps to verify that they are in compliance with the federal securities laws, which could include establishing policies and procedures to appropriately monitor the composition of indices on which futures are based to determine if they are offering security futures products. In analogous situations involving security-based swaps, investment professionals who engage in swap transactions similarly are responsible for ascertaining the characteristics of such swaps to ensure that, if such swaps are security-based swaps, the investment professional is appropriately offering the securities to persons in the United States, and meeting all registration and other requirements associated with those securities.

By the Commission.